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Summaries from the 27th Annual TEI-SJSU High Tech Tax Institute

Authors

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Feature

27th Annual TEI-SJSU High Tech Tax Institute – November 2011

*An annual conference sponsored by the Tax Executives Institute, Inc. and
SJSU Lucas Graduate School of Business - College of Business*

Introduction

The High Technology Tax Institute provides a high quality tax education conference that brings together nationally and internationally recognized practitioners and government representatives to provide expert advice on high technology tax matters of interest to corporate tax departments, accounting and law firms, the IRS and academics.

We encourage you to read the session summaries that follow and to visit the High Tech Tax Institute website (<http://www.tax-institute.com>) to view current and past conference materials in greater detail. If you did not attend the 2011 Institute, we hope this overview of the topics and the depths covered will encourage you to attend a future program.



SJSU MST students attending the 27th Annual High Tech Tax Institute. From left to right: Srividhya Ramakrishnan, Evie Lee, Shauna Rimel, Linda Yung, Sujin Pradhan, Susan Burt, Tim Kelly, Lisa Pan, Chanpheareak (Luis) Chim, and Pingrong Xue.

U.S. International Tax Developments

By: Srividhya Ramakrishnan, *MST Student*

Mr. James P. Fuller commenced the 2011 Tax Institute with his valuable insights and comments on U.S. international tax developments. Mr. Fuller is a partner in the Tax Group at Fenwick & West, LLP in Mountain View, California. In his almost two hour presentation, he briefly covered each of the vast sets of developments and proposals in the international tax field. His 95-page outline addresses in detail, changes and reforms with regard to the foreign tax credit, Section 482, dual consolidated losses, Subpart F income, the new economic substance rules, and proposed and pending legislations.

This summary includes selected developments Mr. Fuller indicated were important with respect to the foreign tax credit and the treatment of transfer of intangibles to foreign country entities.

Foreign tax credit splitters: A foreign credit splitting event occurs when a domestic corporation claims foreign tax credit with regard to related income earned by its foreign corporation. New Code §909 provides that in case of a foreign tax credit split the taxpayer can include the foreign tax credit only in the same year its related foreign income is taken into account for U.S. tax purposes.

As per Notice 2010-92 if a foreign tax credit splitting occurs between a domestic corporation and a §902 corporation, then the FTC paid or accrued will not be considered for the FTC computation under §902 or §960 until the related foreign income is taken into account by the related §902 corporation for tax purposes.²

Mr. Fuller explained the above ruling using the following example:



“US, a domestic corporation, wholly owns CFC-1, a country A corporation. CFC-1, in turn, wholly owns CFC-2, also a country A corporation. CFC-2 is engaged in an active business that generates \$100 of income. CFC-2 issues a hybrid instrument to CFC-1, which is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. CFC-2 accrues (but does not pay currently) interest to CFC-1 equal to \$100. As a result, CFC-2 has no income for country A tax purposes, while CFC-1 has \$100 of income which is subject to country A tax at a 30% rate. For U.S. tax purposes, CFC-2 still has \$100 of earnings and profits (the accrued interest is ignored since the U.S. views the hybrid instrument as equity), while CFC-1 has paid \$30 of foreign taxes. Under the new splitter rule, the related income with respect to the \$30 of foreign taxes paid by CFC-1 is the \$100 of earnings and profits of CFC-2.”⁹

Section 901(m) – Denial of FTC: In general, corporations can claim FTC only to the extent of U.S. tax liability on foreign source income. In the case of covered asset acquisitions, when a U.S. corporation

acquires a disregarded entity in a foreign country it is not considered a corporation for U.S. tax purposes, but is instead an asset acquisition with a basis equal to its fair market value. This basis is not necessarily the same as the basis used for foreign tax purposes. The difference would result in more depreciation deduction for the U.S. corporation, thus reducing the U.S. taxable income whereas for foreign purposes, depreciation would be less thus resulting in more foreign tax payment. In order to avoid claiming more FTC and less U.S. tax liability any foreign tax credit arising out of such covered asset acquisition is denied for a domestic corporation.

Following are the categories of covered asset acquisitions mentioned by Mr. Fuller in his outline:

- “(a) A qualified stock purchase for which a §338 election has been made;
- (b) Any transaction treated as an asset acquisition for U.S. income tax purposes and as a stock acquisition (or disregarded) for foreign income tax purposes;
- (c) Any acquisition of a partnership interest if the partnership has a §754 election in place; and
- (d) Any other similar transaction as identified in regulations.”⁴

Mr. Fuller also provided several examples to explain the complications involved in computing the disallowed portion of foreign tax credit as the foreign asset keeps earning revenues and matching them to its U.S. value.

Section 960(c) FTC: Section 960 allows a deemed paid credit for deemed dividend otherwise paid directly to the domestic corporation by a foreign CFC. As per §956, if a CFC provides credit support or loan payment to its domestic corporation, it is considered as deemed paid dividend. Since it is a payment made by a foreign corporation to its U.S. parent without going through a chain of high tier or low tier CFC, the amount of foreign tax paid is higher if it is a high tax rate CFC. Therefore the amount of credit under §960 would be greater than §902 deemed dividend credit. Under the new rules under §960(c) foreign tax credits claimed through a deemed paid dividend credit is limited to the amount of foreign tax incurred had it been an indirect dividend distributions. This provision applies to all §956 loans after 2010.

Intangibles: Section 367(d) states that “If a U.S. person transfers intangible property that is subject to section 367(d) and the rules of this section to a foreign corporation in an exchange described in section 351 or 361, then such person shall be treated as having transferred that property in exchange for annual payments contingent on the productivity or use of the property. Such person shall, over the useful life of the property, annually include in gross income an amount that represents an appropriate arms-length charge for the use of the property.” Thus §367 does not recognize §351 transfer to a foreign corporation as that of a corporation. Hence the transfer is not tax-free. In case intangible property is transferred through a similar §351 exchange, it would result in imputed royalty for the domestic corporation. For the purposes of this section as per the changes stated by Mr. Fuller, intangibles include goodwill, going concern value and workforce in place. Mr. Fuller emphasized that this is an important issue because any foreign branch could be classified as intangible based on the above provision.

Mr. Fuller covered in detail a lot of changes with respect to international tax and their impact on Silicon Valley companies. He also suggested that the tax departments be vigilant towards upcoming changes as these would affect their tax planning to a greater extent. He concluded by mentioning the territorial proposal from Congressman Camp and emphasized the need for companies to keep up with the international developments and reforms.



28th Annual High Tech Tax Institute

November 12 and 13, 2012

Crowne Plaza Cabana

Palo Alto, CA

Registration Opens August 2012

Topics include: Patent boxes, business restructuring, IP migration, M&A practice, IRS practice and procedure, state tax and emerging issues, post-election outlook

<http://www.tax-institute.com>

Compensation Issues in Today's Global Workplace

By: Shauna Rimel, *MST Student*

Mary Hevener, Peter Klinger, and Ken Guilfoyle discussed various compensation issues in today's global workplace.

Ms. Hevener, a partner in Morgan Lewis's Employee Benefits and Executive Compensation Practice, explained requirements that must be met for travel and per diem expenses to be deductible for corporate tax purposes and excluded from wages. Ms. Hevener also discussed state tax complexities for people working in more than one state.

Ms. Hevener began her discussion with the two basic requirements for travel to be deductible. The worker must (1) have a tax home and (2) be away from the tax home overnight. This sounds straightforward until you ask the question "What exactly *is* a tax home?" It's easy to determine the tax home for an individual who only has one work location, but how do you determine the tax home for a person with multiple work locations? Can a person's permanent residence be their tax home? Is it possible not to have a tax home at all?



Three factors are used to determine whether a person's "permanent residence" can be treated as his tax home (per Rev. Rul. 73-529): (1) whether the person lived at his residence while working in the vicinity, (2) whether the person duplicates living expenses when his work requires him to be away from his residence, and (3) whether the person has not abandoned his historical place of lodging, has family member(s) living at his residence, or frequently stays at his residence. Taxpayers lacking a principal business location or a permanent residence are itinerants that can *never* deduct travel expenses because their home is wherever they happen to be working at the time.

Ms. Hevener explained that certain criteria must be met for travel reimbursements to be excluded from a worker's income. In addition to having a tax home and being away from the tax home overnight for a period of time not expected to exceed twelve months, meal and lodging per diems cannot exceed the federal per diem rates, per diems must be paid under an accountable plan, and workers cannot have the option of receiving additional compensation in lieu of a per diem.

"Accountable" plans must meet four requirements: (1) expenses must be paid in connection with services performed, (2) expenses must be substantiated, (3) expense advances must be reasonably calculated not to exceed the amount of anticipated expenditures, and (4) allowances in excess of

substantiated expenses must be returned. If these requirements are not met, the plan is considered “nonaccountable” and all advances and reimbursements must be reported as W-2 wages.

Ms. Hevener then explained state tax issues affecting today’s mobile workforce. She explained that each state sets criteria determining whether income is taxable in the state and that most states have a minimum number of workdays in the state before the state income allocation rules apply, but that this is not always the case. Employers often have difficulties with multistate taxation because the rules differ from state to state, income allocation rules are poorly written in some states, and it is difficult for employers to track the number of days each employee works in various locations.

Mr. Klinger, a compensation and benefits partner at BDO, discussed global stock-based compensation issues. Mr. Klinger explained that some U.S. parent companies and foreign subsidiaries enter into recharge agreements, which are usually negotiated with the foreign taxing authorities. When a recharge agreement is in place, the foreign subsidiary pays the U.S. parent company an amount equal to the spread between the cost of the shares and the option price when the award is exercised or vested. Mr. Klinger explained that recharge agreements could be advantageous when structured correctly because they allow the foreign subsidiary a tax-free mechanism to repatriate cash to the U.S. parent while increasing the foreign subsidiary’s foreign deductions. Potential disadvantages of recharge agreements include the potential increase in social security taxes owed in foreign countries, increased compliance costs with regard to foreign withholding requirements, and the possibility that the equity award could be taxable in multiple countries. Mr. Klinger explained that equity awards are usually allocated to various countries based on the employee’s residency as the equity awards vest, and that this can be problematic as many companies rely on human resources databases that only track the employee’s most recent move.

Mr. Guilfoyle, a Human Resource Management manager at BDO, concluded the panel discussion by explaining how employers can equalize financial consequences for their employees who accept international assignments. Mr. Guilfoyle explained that purchasing power can be equalized by a cost-of-living adjustment, that housing can be equalized by providing a housing allowance, and that social security taxes can be managed with a totalization agreement. Mr. Guilfoyle explained that companies need to be aware that there is always a permanent establishment issue when employees are working in foreign countries on short- and long-term assignments.

Selected Developments in Tax Administration; Structure, Policy and Procedure.

By: Tim Kelly, *Journal Editor, MST Student*

The luncheon program for the first day of the Tax Institute included Diane Ryan, Of Counsel with Skadden, Arps, and former IRS Chief of Appeals, discussing recent changes at the IRS designed to improve the agency's administration of international tax and transfer pricing rules. Reorganization of the international examination functions combines the Advanced Pricing Agreement program (APA) and the Mutual Agreement Program (MAP) to create a more efficient structure for handling transfer pricing issues. The APA program, formerly under the Office of IRS Chief Counsel, will move to the Office of Transfer Pricing Director (headed by Sam Maruca) under the Large Business & International (LB&I) Division's international operation. The latest in a series of changes by the agency, this restructuring is driven by the following: an increase in APA applications, the growing backlog in processing APAs, a majority of cases involving foreign-initiated adjustments, and increasing budget deficits and revenue pressures in all jurisdictions. To meet the goals of efficiency and reduced processing time, the new structure calls for the following: earlier identification of strategic issues, continuity of personnel assigned to a case, hiring of additional specialists, training, and consistency of position nationwide. As with any reorganization, this is a work in progress, and it will take time to realize the benefits of these changes and the impact on taxpayers and tax administration.

Ms. Ryan spoke briefly on changes in the IRS appeals function, noting that joint (LB&I) Division/Appeals Fast Track Settlement program (FTS) cases are up 50%. The program offers taxpayers the opportunity to resolve disputes earlier in the examination process, reducing the time and expense involved for both parties. Additionally, a helpful [summary chart of IRS authority statements](#) and their binding affect on appeals officers was provided.

Final remarks included more detail with regard to APA substantive issues. An APA is a contract between a taxpayer and one or more taxing authorities specifying the pricing method applied to related company transactions. The benefits provide certainty for prospective tax treatment and the financial reporting of potential tax liabilities. An APA can help the taxpayer frame actual and potential transfer pricing issues by being proactive and potentially reducing the costs associated with audit defense and preparation of documentation.

On average, it takes between 26 and 44 months to execute an APA depending on whether it is a unilateral or bilateral/multilateral (more than one tax authority) agreement. Renewals can take 23 to 40 months. APAs typically run for a period of five years. User fees range up from \$50,000 and renewals are around \$35,000. The number of various penalties continues to increase. They are typically asserted in audits and focus on adjustments rather than methodology or pre-transaction analysis because transfer pricing adjustments tend to yield the largest deficiencies. The 20% and 40% penalties can have a significant impact on reporting and senior management.

Social Media and Internet 2.0: How Do Tax Rules Fit In?

By: Linda Yung, *MST Student*

With the roles of social media and the Internet rapidly expanding, a panel of tax experts discussed the tax implications associated with this new and developing area of business. The panel consisted of Taylor Reid of Baker & McKenzie LLP, Buff Miller of Cooley LLP, Zachary Perryman of PwC, and Eric Ryan of DLA Piper. The topics included a case study, voting control issues for company founders, equity compensation, international tax with respect to virtual economies, and transfer pricing difficulties associated with intellectual property (IP) and social media.

The case study involved a social networking site named Lollol.com (“LOL”) that enables users to customize their user experience. Currently, LOL’s operations are located in Redwood City, CA, but it expects robust worldwide growth. Its current revenue is from advertising and platform licensing. Future revenues could include media distribution, sale of goods and services, and data licensing. In order to address performance issues with the EMEA and APAC markets, LOL’s founders are considering establishing infrastructure operations in regions outside of the US. One issue raised from the case study is how to characterize the revenue from social media streams given that it can include revenue from virtual goods and virtual currency. The significance of LOL is that it represents many other start-up companies in Silicon Valley and applies to other business models such as cloud computing.



The next topic dealt with voting control issues that company founders face when venture capitalists are involved. The panel suggested one method for founders to retain control is to exchange some of their existing common stock for a new class of high-vote common stock. Another method is to distribute a new class of high-vote common stock to the founders. However, there are tax considerations to receiving high-vote stock if there is a material value-differential because the excess value cannot qualify as part of a tax-free exchange. The question then becomes whether the excess value is considered to be compensation or a distribution. In addition, there are tax considerations as to whether the low-vote stock qualifies as voting stock or not. The key factor to make this determination depends on the low-vote stocks’ right to participate in the election of directors.

Equity compensation is another challenge facing social networking companies. Many new companies short on cash find that offering equity compensation helps attract and retain the best and the brightest workers. It also gives workers incentives to work diligently and cooperatively for the benefit of the company. The speakers mentioned two common forms of equity compensation: nonqualified stock options and restricted stock units. The nonqualified stock option is a right to purchase stock at a predetermined exercise price and generally vests over time, giving further incentive to workers to remain with the company. The restricted stock unit is a grant valued in terms of company stock, but company stock is not issued at the time of the grant. It also has a vesting requirement for

distribution. There are tax consequences to both these forms of equity compensation, and each must be carefully weighed with respect to the company's expected IPO date or change in control.

Subsequently, the speakers discussed the topic of international tax with respect to virtual economies. The introduction of virtual currency and virtual goods brings about new challenges to revenue recognition. The difficulty here lies in the characterization of the revenue. Should the transaction be classified as sales, services, a lease, or as a royalty? In order to classify revenue, the speakers suggested looking carefully at all the facts and details of the company and its revenue stream. It is also important to understand how the different pieces of the company's operations fit together. Other difficult areas include: difficulties with sourcing services income, PE (Permanent Establishment) and effectively connected income, subpart F considerations, and territorial division of interests.



The last topic involved transfer pricing difficulties associated with intellectual property (IP) and social media. Oftentimes with social media and internet companies, transfer pricing deals with transfers of IP. The issue includes both identifying the IP elements, and then matching that with an appropriate transfer pricing method. Social media has many other such intangibles that are not typical. According to the speakers, the optimal solution is for the taxpayer to use various methods and assumptions in their analysis to

converge on the chosen inter-company amount. As noted by the panel, the area of social media and the internet is like the Wild West of years past. So far there are no established laws or code sections and only a handful of cases to serve as guidance. As a result the current environment creates some interesting tax challenges and potential opportunities for tax planning.



Spotlight on Transfer Pricing

By: Pingrong Xue, *MST Student*

Transfer pricing was an important topic at the 27th Annual High Technology Tax Institute. It was discussed from four different perspectives by Sean F. Foley from KPMG, John E. Hindings from the IRS APA program, Fred C. Johnson from the IRS A&IC, and Craig A. Sharon from Binham McCutchen LLP.

IRS Organization Change: The IRS continues its reorganization effort to improve the efficiency of its international operations. In October, 2010, the IRS brought together the Large and Mid-Size Business (LMSB) division and the international division, and it renamed the division the Large Business and International (LB&I) Division. In 2011, the Advanced Pricing Agreement (APA) and the Mutual Agreement Procedure (MAP) were moved from the office of IRS Chief Counsel to the office of Sam Maruca, the new director for Transfer Pricing Operation in LB&I. The two programs were merged into the new Advance Pricing and Mutual Agreement (APMA) program. Not only was the new APMA program nearly doubled with the combined staffing of the original APA and MAP programs but it also expanded the operation from four to twelve locations.

Cost Sharing: Sam Maruca, the new director of Transfer Pricing Operation signaled the potential new direction of cost sharing. The temporary and proposed cost sharing regulation will expire in December of 2011. The final regulation was issued after the conference in December of 2011.

Taxpayer-Initiated Adjustments: Taxpayers who operate in high-penalty countries such as Canada and Germany might wish to take preemptive measures in these countries by initiating the transfer pricing adjustments. There is no clear answer as to whether or not taxpayers may receive relief for double taxation if they initiate the transfer pricing adjustment.

China Business Trust: The China Business Trust (CBT) is a rather complicated business structure with potential tax savings. Under the structure, the commission earned by CBT is not taxed by China or the U. S. It is almost too good to be true, with the risk of either country closing the loophole. The fact that the IRS does not accept unilateral APA could be a sign for change from the U.S.



International and transfer pricing issues were a common theme of the conference. The signal from the IRS and the Treasury Department is loud and clear: international issues are the top priority of their agenda.

State Tax Issues Affecting Technology Companies

By: Chanpheareak (Luis) Chim, *MST Student*

This Institute session was presented by Rocky Cummings, Partner, BDO, George Famalett, Partner, PwC, and Kimberly M. Reeder, Partner, Morgan, Lewis & Bockius.

The discussion centered on sales tax nexus issues and their effect on technology companies. As many states face budget deficits, they often become more intent on ensuring all possible taxes are assessed and collected, including on multistate sales transactions. Mr. Cummings pointed out that the *Quill* decision requires companies to have a physical presence in a state to collect sales tax from buyers. However, there is a question as to how much physical presence would mandate the sales tax responsibility for companies with multistate transactions. For example, in 2008, New York imposed "click-through nexus" by enacting a new law to establish nexus between a vendor and New York when a vendor compensates a New York affiliate for referrals to a New York resident buyer. The law applies if vendors pay New York affiliates for such referrals and make sales of at least \$10,000 during a four quarter period from such referrals.

As new technologies continue to emerge, products change faster than the law. It will be more difficult to determine the nexus for companies that use the cloud computing platform, which has made it easier to reach customers across state lines. A company should be careful in developing new products and services and licensing any tangible assets. A company should look at contracts and marketing because the line item for the revenue should be aligned with the contract terms. More importantly, what to put on the contract should be definitive.

Additionally, Ms. Reeder pointed out that when companies are not sure if they are subject to the sale or use tax in states in which they have customers, they should look to a product descriptions. Also,



Ms. Reeder added that they should look into whether or not such transactions with the states are subject to a tax or if there are any tax exemptions. Ms. Reeder recommended that the company should read the statutes carefully.

The cloud computing platform has changed how the *Quill* decision addresses physical presence to determine nexus. In addition, as each state looks to reduce its budget deficit, it looks to raising more revenue. Multistate companies face many challenges, as the law is

likely to change rapidly regarding nexus. A company must be apprised of updates of nexus and tax base rules for each state because any changes could easily affect the business operation.

Accounting for Income Taxes

By: Susan Burt, *MST Student*

A panel of seven tax professionals from CPA firms and industry discussed the updates regarding accounting for income taxes as well as the SEC's recent comment letters as they relate to accounting for income taxes.

The Securities and Exchange Commission (SEC) is required to review public company filings every three years. In a typical review the SEC staff provides comments where disclosures could be improved upon and the registrant responds to the comments until all issues have been resolved. After the comment period has ended and issues have been resolved, the SEC publishes the comment letters on its website. Published comment letters provide valuable insight to the SEC's hot topics and are useful in improving upon financial statements and disclosures.

In the past, SEC staff comment letters have focused on liquidity issues, loss contingencies and impairment issues noting that sufficient information must be disclosed to allow an investor to make an informed decision about financial condition and operations. More recently, the SEC has focused on disclosures regarding undistributed earnings of foreign subsidiaries where the U.S. parent company has considered those earnings permanently reinvested. Some of the more salient points on this issue were presented and discussed.

Permanent Reinvestment of Earnings: The SEC staff has inquired about a company's policy in accordance with ASC 740 (formerly known as Statement 109: Accounting for Income Taxes) whereby there is a presumption that all undistributed earnings will be transferred to the parent entity unless the parent entity has evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrates that remittance of earnings will be postponed indefinitely. A company should consider its past experiences of foreign cash repatriation with regard to its position of permanently reinvested foreign earnings. The SEC has commented on the juxtaposition of a company's past repatriation activity to a company's position of permanently reinvested foreign earnings for further explanation.



Liquidity Related Disclosure: The SEC staff has commented on the need for expanded liquidity disclosures particularly if a company's position is to permanently reinvest foreign earnings. The SEC believes that although a company may have the intent to fund U.S. operations through ongoing cash flows or borrowings, expanded liquidity disclosures should include the amount of cash held by foreign subsidiaries that would be subject to potential tax if repatriated to the U.S. The SEC looks to Item

303(a)(1) of Regulation S-X whereby a “Company should identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in a material way.”

Undistributed Earnings of Foreign Subsidiaries: SEC staff comment letters have included inquiries as to why a company believes it is not practicable to determine the amount of unrecognized deferred tax liability related to undistributed earnings to foreign subsidiaries. Under ASC 740, whenever a deferred tax liability is not recognized, certain disclosure requirements are required such as a description of the types of differences, cumulative amount of each type of differences and amount of unrecognized deferred tax liability for differences, if practicable. In some cases, it is not practicable to determine the amount of the unrecognized deferred tax liability. In most cases, U.S. companies do not provide U.S. deferred taxes on undistributed earnings of foreign subsidiaries because 1) it is impracticable to accurately calculate the amount of deferred tax liabilities related to undistributed earnings and 2) most companies do not have the intention of repatriating foreign earnings. However, in light of the SEC comments on this topic respondents have added additional disclosure that it is not practicable to calculate the potential deferred tax liability.

Summary: In the recent period, the SEC review process has focused on company disclosures with regard to accounting for income taxes particularly where a registrant has significant earnings from foreign subsidiaries. The SEC believes that U.S. parent companies with significant undistributed foreign earnings might not be sustainable and registrants should consider additional disclosure requirements in their public filings.



Dave Gaul, VP Tax for Cypress Semiconductor (pictured above), moderated the panel consisting of Chad Bowar – Ernst & Young, Scott Jaconetty – BDO, Ty Kanaanah – PwC, Jeff Sokol – Deloitte, Jim Songey – Grant Thornton, and Rusty Thomas – KPMG.

IRS Examination and Appeals – Tools and Techniques

By: Evie Lee, *MST Student*

A panel of three esteemed tax leaders, Patricia Chaback, Industry Director for the Communications, Technology, and Media (CTM) Industry for the Internal Revenue Service's Large Business and International Division (LB&I), Larry R. Langdon, Partner with Mayer Brown LLP and former Commissioner of the Large and Mid-Size Business Division (LMSB) of the Internal Revenue Service (IRS), and Diane Ryan, Of Counsel with Skadden, Arps, Slate, Meagher & Flom LLP and former IRS Chief of Appeals, discussed various issues relevant to appeals management and shared their expertise on how to execute a smooth examination.

Ms. Chaback started the discussion with a brief overview of the IRS' reorganization of its LB&I Division. Among other things, Ms. Chaback believes that the restructuring will better serve the public by pooling resources together to increase efficiency, creating a network of issue management teams who have expertise in certain areas, and bringing new perspectives to the issues. One evolving area is the Uncertain Tax Position (UTP) schedule and how the phase-in of this schedule has led to questions about the need for the Schedule M-3. Since these schedules can be used to more efficiently determine which taxpayers to audit and pinpoint specific audit areas, LB&I sees this concern as a means to further encourage discussions with the taxpayer on the UTP before Information Document Requests (IDRs) are issued. During this current trend of uncertainty, more guidance is needed.

Ms. Ryan explained an alternative dispute resolution process known as "Fast-track". The goal of this new process is to obtain a resolution at the beginning of the appeals process versus at the end. In order to achieve this goal, both sides need to keep an open mind, all cases must be determined on a facts-and-circumstances basis, open discussion is encouraged, and both sides must be willing to "put their cards on the table." Under the traditional appeals process, cases are resolved in an average of 400-600 days, whereas under Fast-track, 83% of cases are resolved in an average of just 80 days. This relationship approach results in around 5 to 7 times faster resolution that will translate to saved resources on both sides.

Mr. Langdon outlined the Compliance Assurance Process (CAP) program and how it has benefited its participants. CAP was an invitation-only pilot program that started in January 2005 with 17 large corporate taxpayers, which has since grown to include 140 corporate taxpayers. Due to its success, on March 31, 2011, the IRS announced that this program would become permanent. Taxpayers in the CAP program work with IRS examiners to identify and resolve issues as they arise during the tax year prior to filing their returns, which improves both currency and transparency and strives to achieve a "real-time audit" approach towards compliance. This shortens the exam cycle, reduces uncertainty, and frees up audit resources. As the program is in its infancy, it also comes with



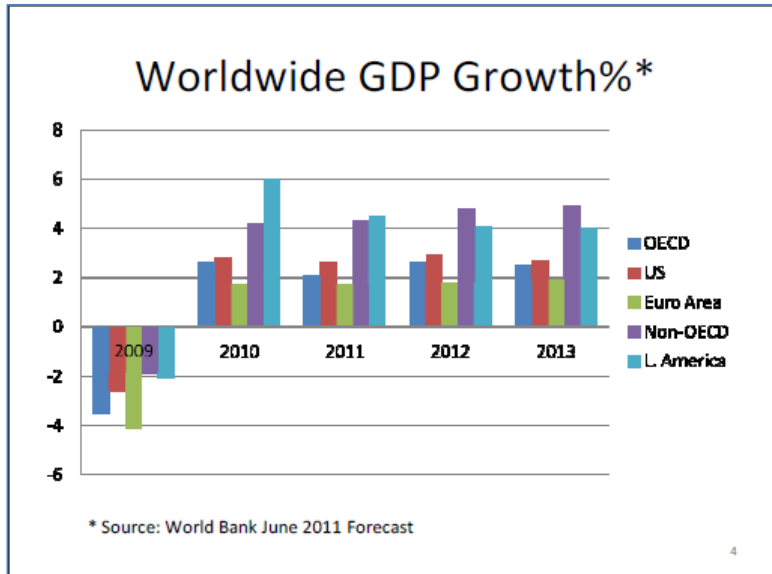
its drawbacks and is not equipped for “emerging issues.” Accordingly, a taxpayer may end up being an experiment for the IRS to set new policies. Additionally, a taxpayer is also susceptible to inquiry regarding transactions before they even occur. At this point in time, there is a lack of clear guidance on what taxpayer profile is best suited for this program and admittance is subjective.



Doing Business in Latin America

By Victoria Lau, MST Student

The World Bank reported that Latin America's GDP grew by 6 percent in 2010⁵⁴, and the growth rates



in 2012 and 2013 are expected to surpass most other regions in the world. This growth is fueled by an expanding middle class with disposable income and high information technology (IT) adoption rates which are spurred by global companies' commodity investments in the region. Mr. Jerry Thompson, VP of Tax from Ingram Micro Inc., introduced these facts as he opened the session on *Doing Business in Latin America*. He portrayed a region with ample opportunities for high-tech companies. This message was repeated by the other two panelists: Mr.

Marcelelo Natale, International Tax & TP Partner from Deloitte; and Mr. Miguel Valdes, Partner from Machado Associados.

The session comprised three parts. First, Mr. Thompson introduced the general economic climate and the IT market trend of the region. He highlighted that the region is in the forefront of technology-generation-skipping with its high adoption of cloud computing and cell phones.

The second part of the session covered tax updates of six major countries. Mr. Thompson explained that Brazil was included due to its economic significance with a population base of 200 million. The other five countries are included as they are economically and politically stable. These other countries are: Argentina, Chile, Columbia, Mexico and Peru. Mr. Natalie covered Brazil, noting the complexity of the VAT system and the challenges a VAT poses to businesses. Mr. Valdes summarized the relevant corporate tax rates, treaty partners, and significant recent and anticipated tax developments for the other five countries. A summary of the key tax facts are presented in Table 1.

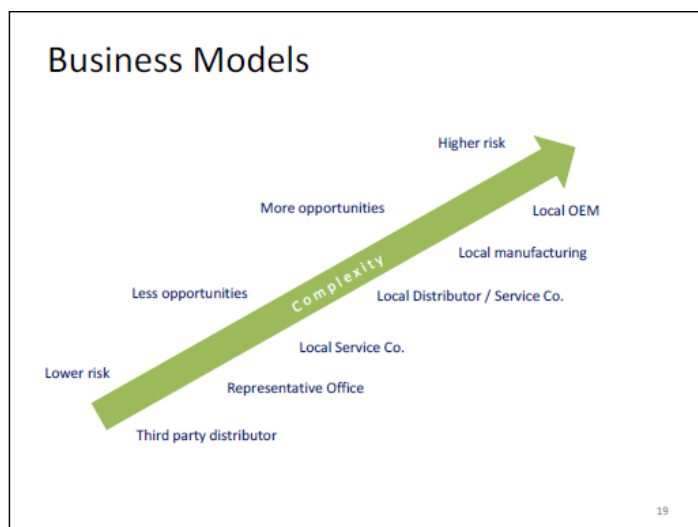
⁵⁴ World Bank. (June, 2011). *World Bank Says Developing Countries Need to Shift From Crisis-Fighting to Policies That Will Sustain Growth* [Press Release]. Retrieved from <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22933230~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>

Table 1 Key Features Comparison

	Brazil	Argentina	Chile	Columbia	Mexico	Peru
VAT	IPI 0-365% ICMS 18% ISS ≤ 5%	21%	19%	16%	16%	17%
Corporate Tax Rate	15%	35%	20%	33%	30%	30%
Dividends Withholding	0%	0%	35%	0%	0%	4.1%
Income Tax Treaty with US	No	Yes	No ¹	No	Yes	No

¹ The Chile-United States Income and Capital Tax Treaty was concluded in February 2010 but is not yet effective.

In the final part, Mr. Thompson gave an overview of the different business models that can be adopted by IT companies seeking to enter emerging markets like Latin America, and he discussed tax



and business factors that may influence the selection.

The rest of this summary highlights three challenges raised by Mr. Natale in his presentation on Brazil’s VAT system: lack of transparency due to the complex tax structure, the uncertainty due to pending “tax wars,” and compliance difficulties.

The Brazilian tax authority focuses on VAT to generate revenue. Mr. Natale explained that income taxation is not a reliable source due to the country’s “roller coaster” economy, hence that tax contributes only one-third of the country’s tax collection. Each level of the Brazilian government has

the authority to impose a VAT resulting in five different taxes on products or services. The federal tax is on manufactured products, *imposto sobre produtos industrializados* (IPI). It is levied on every stage of the production process and on import transactions. The rates vary inversely with the necessity of the product, from 365% to nil.⁵⁵ The 26 states impose the *imposto sobre circulação de mercadorias e services* (ICMS) on the distribution of goods, and the municipalities levy the *imposto sobre serviços de qualquer natureza* (ISS) on services. Mr. Natale said it is possible for VAT to make up 70% of the product or service price. As prices are inclusive of VAT, the tax is not transparent to the taxpayer. Consumers cannot easily differentiate the product value and the taxes paid. Mr. Natale emphasized that it is important for tax professionals to work with their business counterparts to establish the appropriate pricing strategy.

Mr. Natale also explained that the Brazilian VAT system can create uncertainty in tax liability. Although the typical rate of ICMS is 18%, each state has the authority to set its own ICMS rate. Mr. Natale said that some states are locked in “tax wars” by offering lower ICMS rates to attract new investments. In a VAT system, a taxpayer pays tax on the amount that the sale price exceeds the cost of the goods. Mr. Natale explained that the end consumers typically do not reside in states where the goods are manufactured so VAT paid in one state becomes creditable tax in another state; hence “tax wars” ultimately penalize the distributors. The issue of whether states can offer reduced ICMS rates is being decided by the Supreme Court; so tax incentives offered by states may not remain valid.

Reliance on the VAT collection in Brazil has necessitated businesses to collect transactional data. Brazil introduced the Public Digital Bookkeeping System (SPED) which requires businesses to digitize and transmit accounting records, including journals, general ledgers, daily trail balances and balance sheets, as well as transactional documents to support ICMS and IPI payments, and electronic invoicing. Data is transmitted to state authorities and available for use by public authorities and interested parties, including auditors, accountants, buyers, border control, etc. Mr. Natale called the SPED implementation the “silent revolution.” He added that it is geared to collect, and the tax authority is always reaching new historic levels of collection. Most ERP systems, which are focused on management reporting, are unable to collect transaction data at this level. Mr. Natale explained that this compliance requirement creates a barrier for entry to the Brazilian market.

The three panelists summarized by saying that the tax structures in Latin America are complex; however, they emphasized that businesses are highly profitable if you know the rules and “play the game”. Furthermore, they cautioned that if a high tech company does not enter the Latin America market, its competitors would or probably have already entered it.

⁵⁵ IBFD. (June, 2010) Brazil – Corporate Taxation – Country Analyses – 13. Value Added Tax.

Tax Legislative Outlook

By: Tim Kelly, *Journal Editor, MST Student*

For the Tuesday luncheon program, Nick Giordano, Principal, Ernst & Young, provided an overview of the current prospects for tax reform. The House of Representatives is made up of 242 Republicans, of which 87 are freshman, and 192 Democrats. The Republicans hold 47 seats in the Senate, 10 are up for re-election, and the Democrats hold 53 seats, of which 23 are up for re-election. The current deficit in FY2012 is \$3.5 trillion and projected to be \$8.5 trillion for FY2012-2021 under current policies. Potential issues for Congress to consider before the end of the session (112th Congress) include the following: job creation, deficit reduction, tax reform, expansion of expiring tax provisions, and apportionments.

Regarding the upcoming vote by the debt-cutting super committee, it was pointed out that even if the vote fails (which it did), the automatic trigger of \$1.2 trillion in spending cuts will not take place until 2013, leaving Congress plenty of time to come up with an alternative. Meanwhile, President Obama's deficit reduction plan calls for a mix of spending cuts and revenue raisers. Under the plan, \$577 billion are mandatory spending cuts mostly in the area of Medicare and Medicaid, \$430 billion come from interest savings and \$500 million come from winding down the wars in Iraq and Afghanistan. \$1.5 trillion in revenue raisers come from the expiring Bush tax cuts on high-income earners, limitations on itemized deductions and exclusions, and eliminating special interest tax breaks. Achieving these goals will require major tax legislation.

There are a variety of ideas being discussed in Washington to deal with the deficit and increase global competitiveness. One reform gaining attention in Congress is the enactment of a consumption tax. Both parties have members that have advanced a VAT or some other consumption tax to raise revenue. Others suggest moving toward a territorial system and away from the present worldwide system of taxing domestic companies' foreign-earned profits. The recently released proposal from Congressman Camp, chair of the House Ways and Means Committee, moves toward a territorial system by giving a 95% dividend exemption on foreign source active income of CFCs and 95% exclusion on capital gains on CFC sales. Camp and others advocate a corporate rate lowered to 25% in order to attract investment and improve global competitiveness. The implications of lowering the rate are far-reaching. Every percentage point reduction in rates translates to a loss of \$100 billion in revenue over ten years. It also begs the question: can corporate rates be lowered without lowering individual rates? It may be a hard sell to the voters. The final issue in tax reform is the concern that corporate reform will bypass pass-through entities leaving them with higher rates. Assurance to the small business community that any reform will be pursued as "business" rather than "corporate" will help build consensus.

Regardless of the path taken, revenue-neutral tax reform is likely to require significant broadening of the base by reducing tax expenditures. Repeal of corporate tax expenditures such as MACRS, expensing of R&D, and LIFO are some of the most expensive. On the individual side, the exclusion for employer-provided health care, mortgage interest, and reduced tax rates on dividends and long-term capital gains top the list of expensive tax expenditures. Most likely these issues will not be addressed until after the fall 2012 election.

The New Approach to International Tax Rules

By: Sujin Pradhan, *MST Student*

One topic discussed was “The New Approach to International Taxation,” presented by Eli J. Dicker, Tax Executives Institute, John S. Peterson, Baker & McKenzie LLP, Channing Flynn, Ernst & Young LLP, and Barton W.S. Bassett, Morgan, Lewis & Bockius.

Mr. Dicker informed the audience that the agenda would focus on five broad areas: an OECD update, tax reform, FATCA, Notice 2007-13, and the substance over form principles in an international context.

Mr. Peterson started with the OECD update because the U.S. subscribes to the OECD model. One of the areas of importance to OECD is transfer pricing (TP). More companies were locating IP ownership in low-tax jurisdictions such as Singapore, Ireland, and Switzerland. Hence, in 2010, to limit the ability of companies to restructure, the OECD updated the transfer price guidelines (TPG) which consisted of updated guidance on business restructurings and profit methods.

The rules are not perfect; there are still opportunities to disregard the TPG, especially when it comes to taking positions on intangibles. Mr. Peterson pointed out that Chapter IX of the TPG does not define intangibles as required to provide a solid platform for current multinational issues. He gave an example of German legislation where “profit potential” is taxed as an intangible. Therefore, the OECD has a huge task when it comes to providing guidance on what can and cannot be considered an intangible. He also informed the audience that the OECD is currently convening meetings on this topic.

The U.S. Treasury and the IRS face a similar situation. What does it mean to own an intangible? A good example is when there is a legal owner of a trademark as opposed to an owner who enhanced the value of an intangible as a licensee. Mr. Peterson mentioned a common scenario in Silicon Valley where engineers leave companies and start their own company using previous employers’ IP and trade secrets. Hence, more guidance is needed. Cloud computing has centralized what is dispersed among various countries. Have intangibles been transferred? The position of the OECD on “profit potential” and “business opportunities” is going to affect the U.S. position and positions of other countries where U.S. companies have operations.

Mr. Flynn spoke about how companies should prepare themselves in speculation of tax reform. The rules are going to get more complex and tax reform may or may not achieve its intended goal to reduce the deficit, stimulate the economy, and enhance competitiveness. He mentioned the “discussion draft” of an international tax proposal from Congressman Camp that reflects a reduction in corporate tax rate to 25% and forms a territorial tax regime. However, taxpayers would be paying the same tax with the reduced 25% rate because many corporations pay a similar rate now with favored deductions, R&D credit, accelerated depreciation, etc. He emphasized that planning is going to be vital with respect to



moving to a territorial regime and potential repatriation of prior overseas earnings. For example, if a corporation has permanently reinvested foreign profits, it may not have liquid assets but still might be required to pay a tax on such profits.

Some immediate actions that should be taken are to look at qualitative and quantitative effects on businesses, to inform management, and most importantly to influence policymakers. Mr. Flynn also mentioned that 10/50 companies (which own at least 10% but less than 50%) must be aware that they could be taxed on their prorated share of earnings from the beginning of time. Tax practitioners and companies need to keep in mind that this proposal is still in the “discussion draft” stage.

With regard to Notice 2007-13, subpart F income, services must be performed outside the CFC country of incorporation and must have “substantial assistance” from a U.S.- related person. Taxpayers want more clarity on the definition of “substantial assistance”.

FATCA is relevant to technology companies even if it is primarily a banking provision. Taxpayers who use foreign banks to hide investment income will find that this new set of rules is targeted at them. Technology companies could be subject to such provisions because many get involved in activities such as payment processing which is a banking activity.

Mr. Bassett discussed “substance over form” in the international context. One case that companies are watching is a Supreme Court case in India, the *Vodafone* case. India taxes capital gains realized by nonresident parties when they sell stock in an entity located in India. The U.S. tax treaties with India do not prohibit the imposition of Indian tax on capital gains realized by a U.S. resident seller.

In this case, *Vodafone*, a British multinational telecommunications company, bought stock in a Cayman subsidiary which is owned by a Hong Kong (HK) parent. The Cayman subsidiary owned a Mauritius subsidiary which owned an Indian joint venture. The buyer did not apply withholding tax because it was not a direct purchase of Indian stock. This was an indirect disposition of stock situation. India asserted a \$2.6 billion deficiency. *Vodafone* lost in the Lower Court, and the case is now in the Supreme Court. (Note: *Vodafone* won the case in January 2012.)

Mr. Bassett also mentioned a Chinese case involving a U.S. buyer who bought stock in a Hong Kong (HK) entity which owned 49% interest in a Chinese joint venture. The U.S. buyer lost the case because the HK corporation had no office, employees, or any other assets other than the joint venture shares. Therefore, although the U.S. buyer bought stock in the HK corporation in form, in substance it was the purchase of the Chinese joint venture.

As indicated by Mr. Bassett, the key point here is to identify the withholding issue early, to talk to the business team about the right to withhold tax, and to seek indemnification from the seller because substance over form is gaining momentum internationally.

The World Class Tax Organization

By: Lisa Pan, *MST Student*

At "The World Class Tax Organization" discussion, panelists Lorraine McIntire, President of the Santa Clara Valley TEI Chapter, Don Waite, former CFO of Seagate, and David White, former CFO of NVIDIA and Sanmina-SCI, shared insights on the role of tax professionals in larger corporate setting. Specifically, the panelists shared personal experiences and general understandings of how tax professionals can play a broader part in multifaceted business transactions, as well as the unique challenges tax professionals face compared to other functions within a company.

Tax professionals have undergone extensive training to appreciate the complexity of tax law and its practice environment. However, while the tax aspects are important in any transactions, it is often not the sole intention of setting up a business transaction. As a result, the business side typically pours enormous resources into maximizing the business benefits, with tax consequences being a secondary consideration. They tend to "let the tax people worry about the tax," said Mr. Waite in the discussion, and it's not unusual to find



"a separation between the business side and the tax side" in a large organization, when in reality, "the people are all working under the same mission and towards the same goal". As a CFO, Mr. Waite called for closer integration between the two sides, including having tax personnel learn about the transaction in a comprehensive manner instead of just focusing on the tax details and giving the business development team an opportunity to learn the tax implications of their work.

Mr. White pointed out that the separation between business and tax would develop naturally, as tax is a highly specialized field that branches to even more specific areas. The different challenges a tax department faces can already be overwhelming: different filing requirements, addressing IRS audits, keeping up with new laws, reporting to various levels of organizational and regulatory authorities, etc. However, Mr. White agreed with Mr. Waite that without a broader appreciation of the business side, the tax department will become even less involved in business, and in turn, can grow into an even more separated function.

The panelists offered insights on how management could better integrate business and tax, so each side may achieve the best they can. Ms. McIntire stressed the importance of communication among different functions and different levels of an organization. For example, having leaders from the tax department participate in business meetings, even if the discussion is not primarily tax-related can help facilitate understanding from both sides. On the other hand, training should be provided to the business development team to better appreciate the tax complexities of their work. After all, the business details do affect the work of the tax, and the tax outcomes are a part of the business.

"Ultimately", the panelists highlighted in a closing note, "everyone is working together to create value to the company." Ongoing communication is key to enhancing relationships across the board. For shareholders and management, it is what the company can create as a whole that matters the most, not the individual achievements of a particular function.

Federal Domestic and State Tax Updates

By: Evie Lee, *MST Student*

During that last session of the conference, Annette Nellen, professor and director of the San José State University's Masters of Science in Taxation (MST) program and Jennifer Petersen, Tax Partner in KPMG's State Tax practice, spoke about the various federal domestic updates and general state revenue actions and tax trends. The following highlights some of the many topics that were discussed.

Ms. Nellen briefly discussed the 100% bonus depreciation expense of qualified property acquired between September 8, 2010 and January 1, 2012. Such property must be new assets placed in service before 2012 and meet the IRC §168(k) requirements. As a planning strategy for individuals, since individual tax rates may be higher after 2012, it may be beneficial to consider not front-loading depreciation deductions. However, corporate tax rates may decrease, which means that corporations may benefit from accelerated depreciation. The dollar limitation for Section 179 expensing for both 2010 and 2011 is \$500,000 and the reduction in the dollar limit starts to phase out at \$2 million. For 2012, the dollar limitation is \$125,000 and dollar limit starts to phase out at \$500,000, and falls to \$25,000 and \$200,000 after 2012, respectively.

Another federal domestic update covered was the new voluntary settlement program that is part of the "Fresh Start" program announced by the IRS in September 2011. Under this program, eligible employers can file Form 8952: Application for Voluntary Classification Settlement Program (VCSP) to achieve proper compliance with worker classification by making a 10% employment tax liability payment covering the compensation paid to workers for the past tax year. The taxpayer will not be liable for any interest and penalties on the liability and will not be subject to an employment tax audit with respect to worker classification. The VCSP may sound like a good idea, but there are some issues to consider: (1) states may not conform to the federal settlement, which means that there may be state penalties and interest assessed; (2) the effect of the reclassification on any retirement plans, fringe benefit programs, stock options, etc.; (3) the effect on the unemployment tax rate; and (4) the effect of a possible IRS audit.

Ms. Petersen began her presentation with the discussion of why state budget deficits are likely to persist and expected to run at \$120 billion or more per year through FY 2013. Some reasons mentioned include: (1) the federal stimulus has run its course; (2) retail sales and the housing market continue to lag; (3) unemployment remains inordinately high; and (4) the long-term outlook for federal assistance is not good. In order to generate more state revenue, more than 20 states have implemented tax amnesties. For example, Michigan and Washington started an amnesty program in 2011, and Arizona is scheduled to start one in 2012. Other revenue actions include accelerating tax payments, deferring tax attributes, and the sale-leaseback or leasing of state assets. Some states have increased excise taxes on cigarettes and alcohol and implemented taxes on plastic bags. States will continue to make changes to their tax policy in order to bridge the deficit gap, which means that the current trend of more aggressive state audits will continue, resulting in more challenging audits and longer resolution times.

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