Tax Outlook 2021

Bloomberg Tax & Accounting

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- What's next for Europe's tax agenda
- How Covid-19 relief measures could trigger tax filing mistakes
- Cases to watch at the Supreme Court
- The tax consequences of a remote workforce

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The OECD is leading an effort to rewrite how the digital economy is taxed. Above, a traveler looks at a mobile phone at San Francisco International Airport on Dec. 21.

Photographer: David Paul Morris/Bloomberg

Global Digital Tax Rewrite Faces Push for Plan Revamp in 2021

By Isabel Gottlieb and Hamza Ali, Bloomberg Tax

December 29, 2020

- Negotiators aiming for agreement mid-2021
- Concerns over how to reallocate profits could force revamp

Next year signals a potential reboot of parts of the OECD-led effort to overhaul global tax rules as negotiators try to hammer out the final details of a deal.

The pandemic and political disagreements derailed efforts to get 137 countries to agree to a plan in 2020 that would change how and where multinationals are taxed and set a global minimum tax rate.

Countries will face pressure to revamp parts of the plan to get a deal done by mid-2021. At the top of the list is finding a way to break a stalemate over a part of the plan known as Pillar One. Negotiators are grappling with how to reallocate the profits of multinationals—especially tech giants – to countries where they have customers but a limited physical presence.

The stakes are high: If global talks fail next year, a growing number of countries will implement their own measures to collect more revenue from tech giants such as Facebook Inc. and Amazon.com Inc., ratcheting up trade tensions and creating new tax and compliance headaches for companies.

"The question is, what options are out there to turn to and what are those possibilities?" said Catherine Schultz, vice president for tax policy at the National Foreign Trade Council.

'Bellwether'

Other countries will be looking to a Biden administration to bring new ideas to the talks, stakeholders say – especially on Pillar One, after the Trump administration's insistence that those rules be optional raised concerns from other countries.

A meeting of the steering group of countries spearheading the project in March could be critical, said Sarah Shive, vice president of government affairs and counsel at the Information Technology Industry Council.

"I think that's going to be a time that the other members of the Steering Group are really going to be looking to the U.S. to better understand their approach, and is going to be perceived as a bellwether for how things are going to proceed this year," she said.

"I think it would be in the U.S.'s interest to refocus on what would be acceptable to the U.S.," and bring their own proposal to the table, Gael Perraud, deputy director, international taxation and European affairs in the French Finance Ministry, said Nov. 23 at a virtual conference hosted by Oxford University.

OECD Aiming for Digital Tax Agreement Next Year

Oct. 8-9	137 countries agree on "blueprints" of the plan
Oct. 14	G-20 leaders endorse reaching agreement by mid-2021
Jan. 14-15	Public consultation meeting on two-pillar plan
Mid-2021	Deadline for agreement

Source: Bloomberg Tax

The Biden transition team and the Organization for Economic Cooperation and Development declined to comment.

Complicated Definitions

Talks stalled in the fall when countries couldn't bridge divisions over which companies should fall in-scope of the profit reallocation rules. The scoping rules try to define specific criteria by which companies or business lines are "automated digital services" or "consumer-facing businesses," ultimately capturing more companies than just U.S. tech giants.

Those definitions are so complicated that they'll create problems as companies try to figure out whether their business activities are in or out of the rules, according to public comments.

For example, if a multinational company has revenue streams that are both in-scope and out of scope of the rules, then the company will have to make complex calculations. It may need to show sources of revenue and prove that the description of its activities don't match in-scope activities.

While companies have different views on the specifics of the scope categories, "consensus is that detailed scope limitations based on business models do not create a simple model," Business at OECD said in a comment letter published Dec. 16. The group represents over 7 million companies through a network of industry bodies.

This issue is compounded for companies that sell goods, such as tires, that would be out of scope when sold as a component part of a manufactured good, but that can also be sold directly to consumers.

Some companies used a recent public comment period to push for simplifying Pillar One's scope, or suggest ways to do it.

The U.S. Council for International Business, which represents 300 U.S. multinationals, urged the OECD to write the rules as "empirically" as possible. "There should be no opportunity created in the design of the rules for an unprincipled or ambiguous interpretation of the rules by tax administrations," the group said in comments.

"In order to maintain equity within the international tax system, the scope of Pillar One (Amounts A & B) should ideally apply to all industries and business models,". Procter & Gamble Co. said in a letter.

The rules' complexity has also come under fire from tax advocates who say the proposals are unworkable for developing countries that don't have resources to administer such systems.

"You don't have a fair system, and you took it from critically bad on complexity to completely unworkable," said Tove Maria Ryding, policy and advocacy manager—tax justice at the European Network on Debt and Development.

More Concerns

The scope of Pillar One isn't the only outstanding issue.

Developing countries have serious reservations about the plan overall, including binding dispute resolution. Many developed countries and companies say it must be included because it provides tax certainty, but developing countries worry the plan will put them at a disadvantage because they have fewer resources and experience in international arbitration.

Countries must also still agree on how the U.S.'s own global minimum tax regime, known as GILTI, will sit alongside Pillar Two – the plan's global minimum tax. The October blueprint said it's probably politically necessary to give U.S. companies a partial pass on complying with the OECD minimum tax, since they already face the U.S. version, but questions still remain on how all of Pillar Two's rules would interact with GILTI.

A Biden campaign proposal to raise the GILTI rate and have it apply to the effective tax rate companies pay in each foreign jurisdiction – rather than on their blended foreign rate – could also affect the interaction of the two regimes.

"Whether the Biden administration may take some of their campaign proposals on global minimum tax and push those at the OECD" or whether they choose to maintain the Trump administration position on getting GILTI treated as a coexisting set of rules will be a major decision the new administration will need to make early on, said Daniel Bunn, vice president of global projects at the Tax Foundation.

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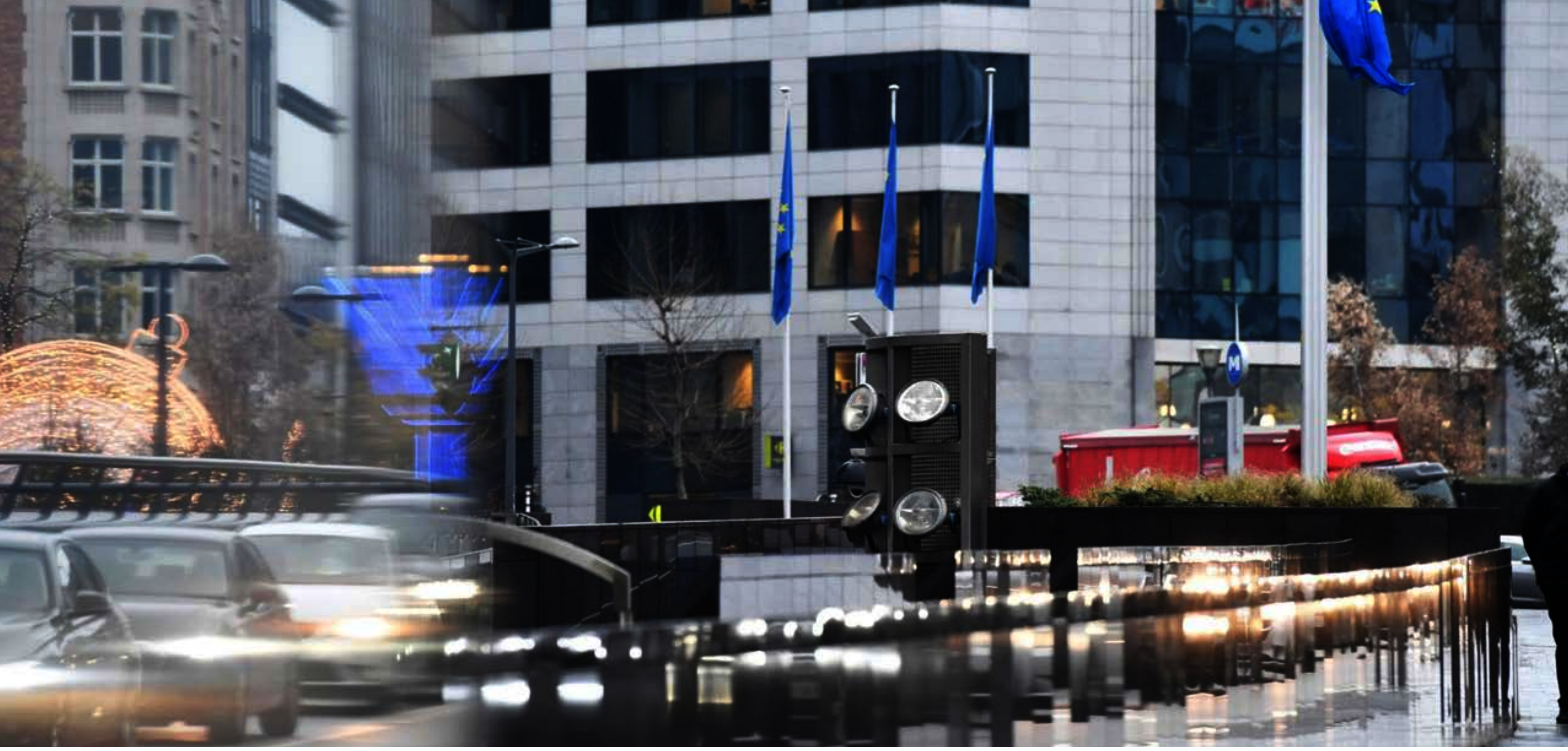

The European Union has said it will propose its own digital tax plan if OECD talks fail.

Photographer: Geert Vanden Wijngaert/Bloomberg

Digital and Green Taxes First on Europe's 2021 Tax Agenda

By Stephen Gardner

December 31, 2020

- Bloc will propose its own digital tax plan if OECD effort fails
- New measures for deterring harmful tax practices, tax dodging

The European Union will have two main tax policy priorities in 2021—finding a way to tax the digital economy and using taxation to meet the bloc's goal of cutting greenhouse gas emissions to net-zero by 2050.

These issues were much discussed in 2020, with digital taxes the focus of attention in the OECD's base erosion and profit shifting initiative (BEPS), and with various green strategies published by the European Commission, the EU's executive.

The 27-nation bloc will publish a plan on business taxation by mid-year, outlining how it will implement the OECD's global blueprint to tax the digital economy, which is currently being negotiated by nearly 140 countries. More detailed digital tax proposals could be published later and will depend on the outcome of the negotiations.

"An international agreement at the OECD/G20 level remains our preferred way forward, as this would bring stability in the global tax framework," the commission said in an emailed statement. "If a global agreement is reached, we will move swiftly to transpose it into EU law."

The Organization for Economic Cooperation and Development is working to get agreement on a plan to overhaul how big technology companies, and other multinationals, are taxed. Part of the plan, known as Pillar One, would reallocate some of the profits of multinationals to the countries where they have users or consumers, while Pillar Two would create a global minimum tax rate.

The OECD has said it will finalize those decisions by mid-2021. The EU says it will be ready to go with its own proposals if the OECD misses that deadline.

Pressing Need

For the EU, agreement on a framework for digital taxation is pressing because such taxes would help fund the bloc's budget. EU leaders at a recent summit approved the budget through 2027, including a decision on EU levies and taxes as resources for the budget.

EU leaders specified that a common digital tax to help fund the budget should be operational from 2023. Paolo Gentiloni, the EU economy commissioner, has said such a levy would replace national digital taxes implemented or considered in countries including France, Italy, and the Czech Republic.

The design of the tax will "take into account the landing point of the current global discussions," the commission said.

"Questions remain on how this levy will be designed and how it will co-exist with a possible Pillar 1 framework," said Olivier Boutellis-Taft, CEO of Accountancy Europe, which represents accountants and auditors.

The EU plan on business taxation should clarify the bloc's intentions on digital taxes and "the prospects of going ahead with an EU solution" if OECD talks fail, said Pedro Marques, a Portuguese center-left member of the European Parliament and its tax subcommittee.

Other taxes and levies in the EU budget include a charge of 0.8 euros ($0.98) per kilo on unrecycled plastic waste that EU countries must pay starting Jan. 1 and a tariff on carbon-intensive goods entering the bloc; the latter won't apply until 2023, but the commission will make proposals for how it will work in the second quarter of 2021.

Green Deal Taxes

Tax is also part of the EU's broad sustainability plan, the European Green Deal, under which emissions must be cut 55% by 2030 compared with 1990, and ultimately to net-zero.

As part of the measures to achieve the reduction, the commission will in the second quarter of 2021 propose to revise the EU Energy Taxation Directive (2003/96/EC), which sets the minimum taxes EU countries must levy on transportation, as well as on heating fuel and electricity.

The revision could bring a crackdown on fossil-fuel exemptions, including those for aviation and shipping fuel, while allowing more favorable tax treatment of green fuels, including electricity from renewable sources and hydrogen.

"The ability to raise revenue in an economically, socially and environmentally sustainable way is the backbone of all other policies," said Kira Peter-Hansen, a Danish Green European Parliament lawmaker and member of the tax subcommittee.

Deterrence Drive

Measures to deter tax evasion and avoidance and to increase sharing of information among the bloc's tax administrations also figure among the EU's 2021 proposals.

The Council of the EU, which represents the governments of EU countries, will formally adopt early in 2021 an update to the EU directive on administrative cooperation in the field of taxation (DAC, Directive 2011/16/EU), which will trigger sharing of information between tax offices on the revenue of sellers on digital platforms.

A further DAC update will follow in 2021, with a commission proposal for sharing information on revenue derived from cryptocurrencies.

EU rules on exchange of information between tax authorities currently don't cover cryptocurrencies. That presents a challenge for tax compliance because it's hard to identify "the relevant intermediaries, the reportable event, the valuation of assets and the available information," according to a November outline plan on the forthcoming DAC proposal.

The EU is also planning to reform the way its influential Code of Conduct (Business Taxation) group works in 2021. This group of country representatives reviews taxes in EU countries that are considered harmful or could distort the EU single market, and pushes the countries concerned to change them. It also judges which non-EU jurisdictions should be included in the bloc's tax haven list.

Decisions on reforming the group will ultimately be made by EU finance ministers, who have said the group's scope should be extended beyond tax distortions to wider features of tax systems that can also have harmful effects.

Through the Code of Conduct group, the EU should be more aggressive in tackling the harmful tax practices of its own members, said Marques.

"Our countries are supposed to thrive together, not to engage in a race to the bottom," he said.

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The European Court of Justice next year will address several state aid cases.

Photographer: Geert Vanden Wijngaert/Bloomberg Finance LP

2021 Tax Cases at Europe's Top Court Have Commission Bracing

By Danielle Myles, Freelance Correspondent

December 28, 2020

- Court will address state aid case involving French utility Engie
- Decisions will also deal with turnover taxes in Hungary, Poland

Europe's top court next year will face landmark state aid cases and a battle over international tax avoidance rules that signal a possible power shift away from the European Commission's executive authority toward member countries.

Cases involving Poland and Hungary could determine the plight of the corporate revenue-based taxes that are cropping up across the bloc, while a Swedish case will dictate how member states implement the Organization for Economic Cooperation and Development's landmark project to combat base erosion and profit shifting (BEPS).

The European Court of Justice's agenda also includes Luxembourg's dealings with French utility Engie—the latest installment in the European Commission's crackdown on corporate tax evasion and one that precedes the bloc's appeal of its 13 billion euro ($16 billion) loss to Apple and Ireland.

The various cases involving allegations of illegal state aid to companies—including those against Poland, Hungary, and Ireland—suggest that various EU tax authorities must distinguish between what they consider to be fair and what is illegal.

"A fundamental issue raised by these cases is that sometimes the European Commission, for understandable reasons, does not like the result of certain structures," Michael Lang, the head of the Institute for Austrian and International Tax Law, said at one of the institute's recent conferences. "But whether they have the legal tools to strike against that structure is a different question."

Turnover Taxes

Poland's retail tax and Hungary's advertising tax are the focus of commission objections to the use of revenue, instead of profit, to measure companies' ability to pay. The commission argues that these taxes breach state aid rules because they disproportionately impact multinationals, but ECJ Advocate General Juliane Kokott recommended in October that the court dismiss the commission's claims.

Her opinion, though not binding on the court's final decision, emphasized member states' right to design their tax structures, pushing back at the commission's desire to dictate the perfect tax. Poland, confident of victory, said recently that it would begin collecting the tax in January.

It's up to member states to design their taxes within the confines of the bloc's rules, and it's the Commission's role to act if those taxes don't respect EU law, said Professor Servaas van Thiel, a member of the European Union delegation in Vienna.

Sweetheart Deals?

The commission's efforts to curtail what it sees as unfair tax competition between member states make Luxembourg a prime target. Along with verdicts on its tax arrangements with

Tax Cases at Europe's Top Court in 2021

Case	Country	Issues	Money at Stake
Retail tax	**Poland**	**State aid**	**329 million euros annually**
Advertising tax	Hungary	State aid	NA
Flat	**Luxembourg**	**State aid**	**20-30 million euros**
Amazon	Luxembourg	State aid	250 million euros
Engie	**Luxembourg**	**State aid**	**120 million euros**
Apple	Ireland	State aid	13 billion euros
Lexel	**Sweden**	**Freedom of establishment**	**12 million euros**
Information exchange	Luxembourg	Data protection	NA
Tax penalties	**Spain**	**Free movement of capital**	**NA**

Source: Bloomberg Tax

Fiat and Amazon, the Grand Duchy awaits the ECJ's decision on whether 120 million euros in tax breaks it granted to Engie over a decade were illegal. The commission claims Luxembourg allowed different entities within the French energy major to treat intragroup financing as debt and equity, thereby avoiding tax on 99% of its profits.

Oliver R. Hoor, a partner at ATOZ Tax Advisers in Luxembourg, said that merely confirmed the general accounting and tax treatment under national law that would apply to similar situations, and therefore shouldn't break EU state aid rules. The commission, he said via email, "seems to be driven by the mantra 'it cannot be what I do not like'," adding that the case will "give a strong signal for taxpayers as to whether the rule of law will be the relevant standard going forward."

Indeed, for these and other state aid cases, Apple's watershed July victory set a high bar to prove a taxpayer has received a selective economic advantage in breach of EU rules. The commission is appealing the tech giant's win—on grounds that it violates EU competition law, a person familiar with the matter told Bloomberg Tax in September—but the consensus is that it faces an uphill battle. Appeals can only challenge findings of law, not facts, and the lower court's 500-paragraph legal analysis may leave little leeway for the ECJ to disagree.

BEPS Speedbumps

A dispute involving Swedish firm Lexel reveals the need for national flexibility in implementing the OECD's BEPS project for fighting tax avoidance. Swedish rules that limit the right to deduct interest on intragroup loans are similar to the so-called "undertaxed payments rule" within the BEPS framework. As this restriction only applies to cross-border—and not domestic—loans, Lexel claims it breaches the EU right to freedom of establishment.

"The outcome of the Lexel case will be relevant to whether EU countries can implement such undertaxed payments rules," said Alexander Rust, a professor at the Institute for Austrian and International Tax Law. While most member states have introduced interest limitation rules in accordance with the EU's Anti-Tax Avoidance Directive, he said EU countries might eventually want to go beyond this and implement an undertaxed payments rule.

The ECJ will also hear cases in 2021 on the theme of rights of taxpayers undergoing investigation. In addition to *État du Grand-duché de Luxembourg v L*, which considers the privacy rights of shareholders, the ECJ will assess the legality of fines imposed on Spanish taxpayers.

Professor Jose Manuel Almudi Cid of the Universidad Complutense de Madrid argues that national rules—which set a minimum penalty of 10,000 euros plus 150% of the tax due—are not proportional and should be amended. "The absence of a limitation period and the amount of the fines make Spain's regime contrary to the fundamental freedoms," he said.

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Virtual State Tax Administration Poised to Stick After Pandemic

By Laura Mahoney, Bloomberg Law

January 4, 2021

- States quick to offer virtual options for taxpayers amid pandemic
- Online offerings popular, but some matters best in person

State tax departments that urgently embraced virtual options due to the pandemic—from routine document signing to audits and dispute resolution—are likely to stay on course after the health emergency subsides.

Tax administrators and practitioners said states generally adapted quickly to offer virtual ways to conduct business when in-person meetings halted and offices closed in March. In the short term, new virtual options are making tax compliance and administration more efficient while continuing to protect taxpayer confidentiality.

"With each day or week that passes, states are embracing the technology more and more," Landon Julius, principal in the transaction tax practice for Ryan LLC, in Kansas City, said.

Based on a sampling of a dozen states reviewed by Bloomberg Tax, agencies are more open now to using email to communicate or receive documents. They've suspended the requirement for wet signatures on many documents and been flexible about deadlines when possible. Taxpayers, their representatives, and agency employees can share screens, discuss matters, or conduct hearings without traveling or being in the same room using video conference platforms like WebEx or Zoom.

In the long term, practitioners said, they would like to keep those options even after in-person meetings resume.

"We've all evolved over the past nine months," said Scott Roberti, managing director and state policy services leader for Ernst & Young LLP. "Some of this is going to stick."

States have surpassed the IRS to some extent in adjustments to virtual tax administration, Bruce Ely, partner with Bradley Arant Boult Cummings LLP in Birmingham, Ala., said. For example, the IRS didn't offer virtual hearings with appeals officers until recently while most states, including Alabama, have been offering them for months.

Remote tax administration hasn't been without its frustrations, but approaches from many state authorities are consistent with recommendations from the American Institute of CPAs for adapting to the pandemic, Jamie Yesnowitz, member of the institute's Tax Executive Committee and a principal in the state and local tax practice at Grant Thornton LLP in Washington, D.C., said. The institute is tracking what states are doing to offer administrative, filing, and payment relief.

Sample Virtual Options for State Tax Administration
Many states adapted to the pandemic with online offerings

Appeals	New York Tax Appeals Tribunal has virtual hearings through Feb. 28, 2021
Audits	Illinois expands it's Fast Track Resolution program for virtual meetings
Correspondence	Oregon Department of Revenue allows electronic document submissions
Deadlines	Texas extends deadline for taxpayers to request dispute hearings
Signatures	California FTB accepts digital signatures for most documents

Source: State tax authorities

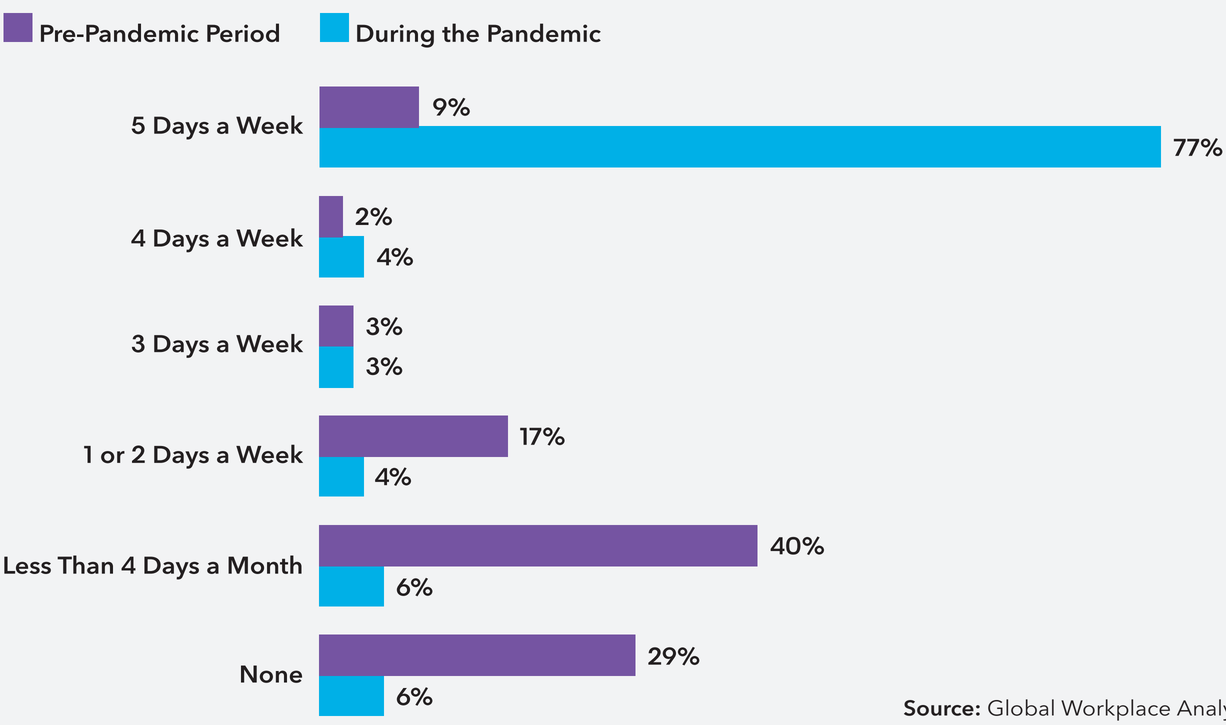
Agencies Modernizing

Pennsylvania, like many states, has shifted 80% of its staff to working remotely. The Department of Revenue is encouraging taxpayers to file appeals and supporting documentation electronically. Appeal hearings are conducted on Skype, and decisions are sent by email instead of USPS. Field audits are mostly taking place remotely, and the chief counsel has waived in-person service requirements for legal actions, Pennsylvania Deputy Secretary for Revenue John Kaschak said in an email.

Tax officials in Illinois, Pennsylvania and at the California Franchise Tax Board said they are considering what virtual options to keep after the pandemic. In Tennessee, virtual taxpayer conferences have been popular and will continue to be offered, and Texas plans to continue using video conferencing for administrative hearings.

"As the pandemic comes to an end, we will evaluate which virtual methods worked well and, in collaboration with the taxpayer community, look into the feasibility to continue those virtual channels," Franchise Tax Board Executive Officer Selvi Stanislaus said in an email.

75 Million Americans Are Working From Home During Covid-19
Percentage working from home pre-pandemic vs. during the pandemic



Source: Global Workplace Analytics

Illinois Department of Revenue shifted to email out of necessity when it had to close its call center at the start of the pandemic. The agency responded to twice as many emails in April and May—40,565, to be exact—than it did in all of 2019, spokesperson Terry Horstman said. Expanding the Illinois Audit Fast Track Resolution program to include virtual audits has resulted in quicker resolutions that avoid formal protests and litigation, Horstman said.

The pandemic has given state tax departments the impetus to adopt new technology if they haven't already, and state legislatures should fund the advances, Bill Backstrom, partner with Jones Walker LLP in New Orleans, said.

'Being in the Room'

The Idaho State Tax Commission has conducted in-person protest hearings only if requested by the taxpayer, and with protocols like social distancing in place. The agency would like appeal resolution meetings to go back to in-person settings, spokesperson Renee Eymann said in an email.

Tax agencies aren't alone in looking forward to face-to-face meetings again. Practitioners said that although they want to keep new virtual options, in some situations they will always choose an in-person meeting.

Oral arguments in appeals or matters that require witnesses are best left to in-person settings, Backstrom said.

"Is there something in the law or the facts where I see a chink?" Christopher Karachale, a partner with Hanson Bridgett LLP in San Francisco, said. "If I'm looking someone in the face I can tell."

With assistance from Michael Bologna in Chicago, Brenna Goth in Phoenix, Jennifer Kay in Miami, Chris Marr in Atlanta, Paul Shukovsky in Seattle, and Paul Stinson in Austin, Texas.

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Photographer: Daniel Acker © 2020 Bloomberg Finance LP

N.Y., California, Others Set to Work Around SALT Deduction Cap

By Sam McQuillan, Reporter

December 22, 2020

- More states to try pass-through business tax
- Some eye mechanism to raise Covid-depressed revenue

High-tax states trying to help residents avert the $10,000 federal cap on deductions for state and local taxes are resuming efforts that were largely sidelined during the pandemic.

A half-dozen states from New York to California are slated in 2021 to take up workarounds to the cap following IRS approval last month of tax mechanisms that seven states have in place for pass-through businesses like partnerships and S corporations.

Some Democrats in Congress have pledged to pursue raising the deduction cap, a move that would likely affect states' actions. Even working with the new Biden administration, however, the effort will be an uphill fight.

Minnesota and Alabama will join in on anti-cap efforts from high-tax states next year with proposed workarounds of their own, and the potential such mechanisms have as much-needed revenue raisers could embolden more states to follow.

The workaround approach the IRS approved has limited appeal, since it applies only to owners of pass-through businesses. Still, as other state approaches were struck down by the IRS, pass-through workarounds remain attractive as the sole option blessed by the agency.

Each state's workaround is unique, although they all essentially use an extra, mostly optional, business-level tax on owners of pass-through businesses, which the businesses can pay in exchange for a credit to redeem on their personal income taxes. Since the federal SALT cap only applies to individuals, it doesn't impact the business-level tax that states created for workarounds.

New York, Minnesota, Alabama

New York lawmakers introduced pass-through workaround legislation earlier this month, which bill sponsors have promoted as relief for taxpayers under financial stress from the pandemic. The bill would align New York's tax code with the IRS's ruling "to provide a common-sense benefit—at no cost to New York State—for the 2020 tax year," state Sen. James Skoufis (D) said in a press release.

In Minnesota, a proposal for a similar workaround is "a lock to be reintroduced" in the next legislative session, according to Mark Haveman, executive director of the Minnesota Center for Fiscal Excellence, a nonpartisan research organization.

"The state Chamber is pushing it and there appears to be considerable receptivity to it in both the House and Senate," Haveman said.

Alabama will consider a proposal in 2021, as well. With the prospects of a special session, that could come as early as

January, according to Bruce Ely, a partner at Bradley Arant Boult Cummings LLP in Birmingham, Ala.

"You will see a number of these bills introduced next spring, likely including our bill, although it will be somewhat retooled to take into account what these other states are doing," Ely said, referring to efforts in Alabama.

If New York and California—where lobbying groups are pushing for pass-through entity taxes—enact the workarounds, even more of the country could follow.

Paying Less, Collecting More

Some states could choose to use the entity-level tax as a revenue raiser in their hunt for money after coronavirus economic blows. Connecticut, home of the first pass-through workaround, has done so.

As part of their 2019 budget, Connecticut lawmakers lowered the redeemable credit's value to 87.5% from 93.01%—which raises the income tax liability of each partner or shareholder but still leaves pass-through owners paying much less federal tax than they had before.

So if a pass-through business in Connecticut pays $100,000 in state income taxes, and that liability flows through to its partners, they now receive a lower credit—$87,5000 instead of $93,001. But because they can fully deduct their SALT taxes, they likely end up paying much less than they would have without the workaround.

If other states enacted workarounds and cut back their credits, they too could collect more taxes while the taxpayer shells out less.

"States are looking for more and more revenue, so this could be an avenue for them to get it without it being too controversial of an item to raise revenue over," said Todd Hyman, a partner and national leader in the multistate tax practice at Deloitte LLP in Philadelphia.

Such a tactic could be especially helpful to states already poised to adopt the workaround, as many high-tax states will be especially cash-strapped going into 2021.

Both New York and California sit right at or slightly below the average state's 5% year-over-year drop in revenue from April to September, and New York Gov. Andrew Cuomo (D) is calling for ways to collect more taxes next year.

Minnesota is even lower on revenue. Its 6% year-over-year drop over the same time period ranks 15th-worst among all states, just four spots behind Connecticut, according to data compiled by the Urban Brookings Tax Policy Center.

Learning From Others

Not many pass-through business owners chose to take advantage of state workaround options last year. That will likely change going into 2021. Now that the IRS has approved the strategy, more states will adopt it, and businesses have time to acclimate to the change, Hyman said.

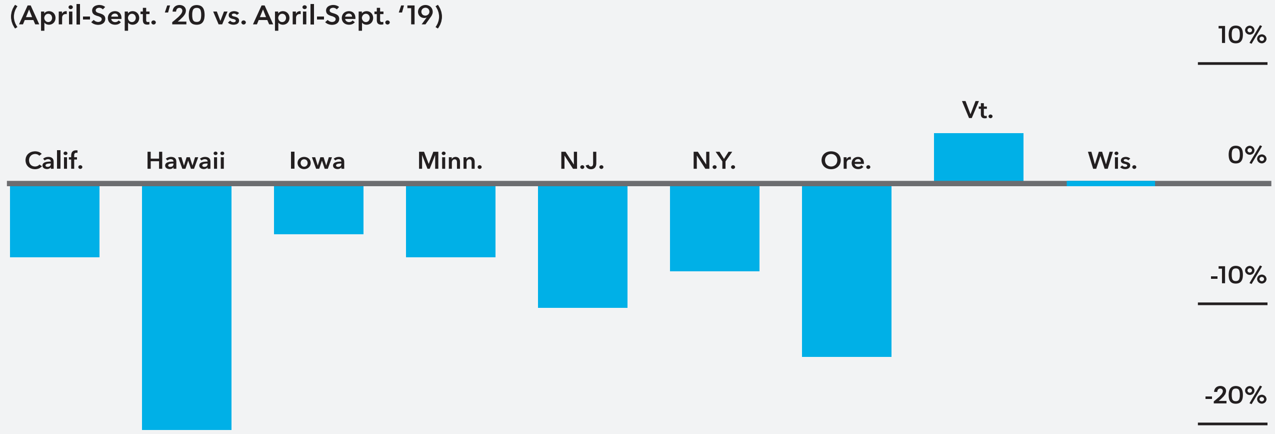
"This is a good time to learn from other states' mistakes and successes," Ely said.

A case in point is Oklahoma's law, which gave businesses just 60 days to decide if they wanted to opt in.

"It didn't really give taxpayers enough time to understand the regime and decide if electing in would be worthwhile." Hyman said. "Other states should want to look at when they make their election date."

The degree of choice pass-through owners have is another consideration for states and taxpayers.

Budget Shortfalls in Highest-Tax States
Year-over-year changes in state revenue
(April-Sept. '20 vs. April-Sept. '19)



Source: Tax Policy Center

In Connecticut, the entity tax is mandatory for pass-through businesses, and owners can't get out of it even if they ask. Louisiana's isn't technically mandatory, but businesses are required to submit extensive information to the state before opting in. Louisiana regulations also require the revenue secretary's approval not to pay the entity tax.

Jaye Calhoun, partner in Kean Miller LLP's New Orleans office, said the information that must be filed could make pass-through businesses much easier to audit.

"That was of concern to clients," she said. "Do we really want to just hand them all this information?"

States tend to like these entity taxes for that very reason: rather than having to pursue all the shareholders, members or partners, they can just pursue the entity, Ely added.

"It decreases the compliance workload on the state level," he said.

Ideally, Calhoun said, the next state that adopts an entity tax would make electing in and out easier for businesses.

"That was a concern," she said. "Do we really want to sort of risk the possibility that the department will not allow a termination of elections, even if the federal tax law changes?"

Hitting Pause

If Democrats who oppose the deduction cap were to succeed in changing it, fewer states would bother with workarounds, as the already select group of taxpayers that would realize the benefit would shrink even more, said Jess Morgan, senior manager of state and local tax EY's national tax practice in Washington.

Among states that already have the tax, Morgan said more states are likely to follow Connecticut and lower their credits.

Either way, the cap is set to expire in 2025, which should give states pause in creating these workarounds, she said, as they would have left in place the framework for a new tax on pass-through entities doing business in these states. That raises a key issue around jurisdiction.

"The workarounds are brought into place because the state has jurisdiction to tax individuals that are earning income in the state," Morgan said. "What we've done is transformed that, and we are asserting a tax on the privilege of doing business or earning income in the state, so now jurisdiction is over the legal entity."

Once the pass-through entity has filed its return, presumably the facts of that business, such as how and where it earns income, would have to change if that business wants to stop filing in the state in the future, she said.

"Opting in is not a decision to make lightly," she said.

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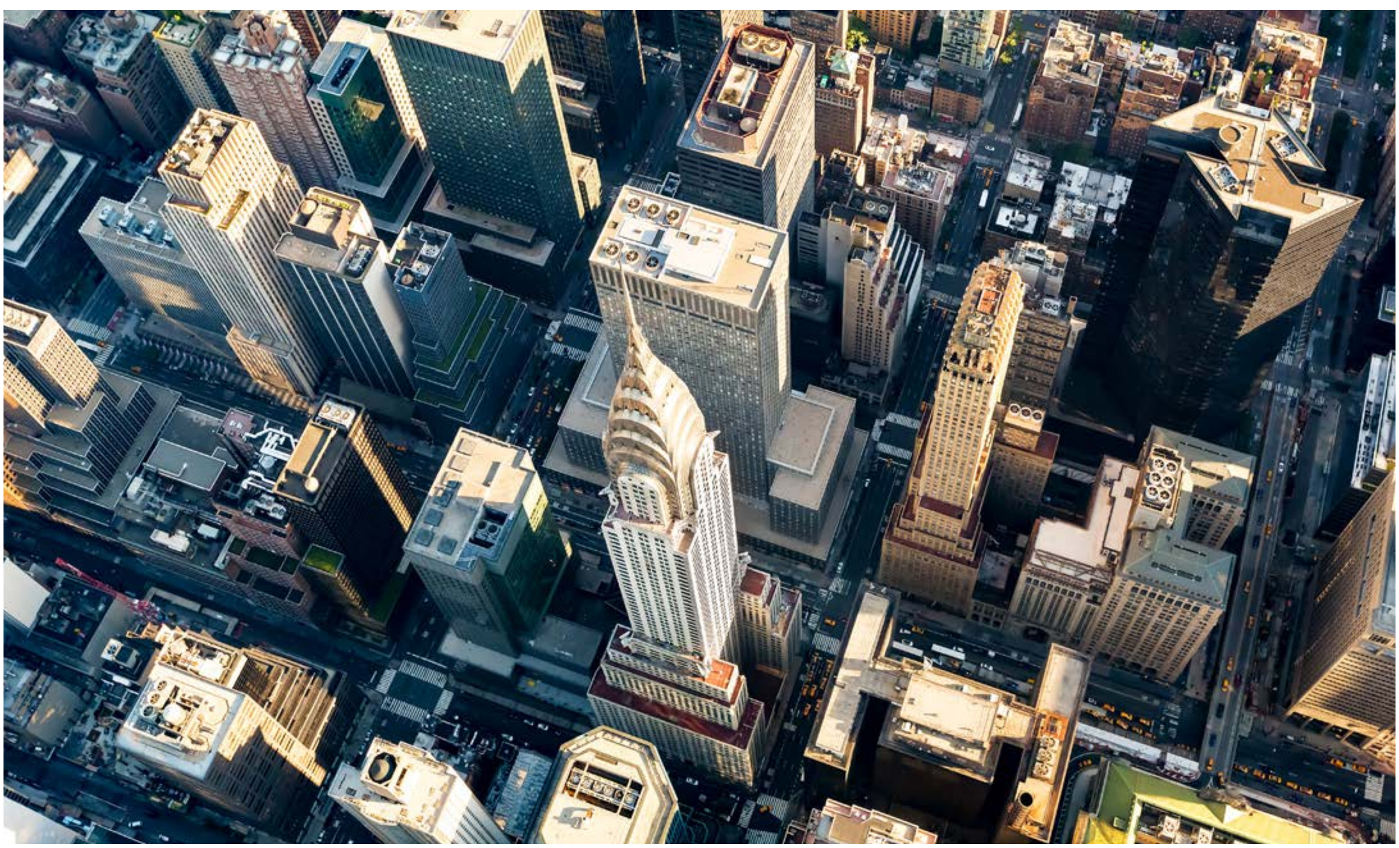

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Troubled Debt, Mergers Lurk as Top Loan Loss Revamp Concerns

By Nicola M. White, Reporter

December 22, 2020

- Key credit loss accounting standard complaints to get aired in 2021
- U.S. accounting rulemaker wants to work out quirks before 2023

When Huntington Bancshares Inc. announced this month it would merge with TCF Financial Corp. to become a top 10 regional bank, the bankers explained to analysts that they'd have to "double count" the losses on the loans they acquired in the deal.

A quirk of a major new accounting rule forces banks to set aside more reserves than in the past to cover future losses, even on healthy loans they acquire in a sale or merger. This dings their earnings and value to shareholders. Banks describe it as a "double count."

This part of the current expected credit losses (CECL) accounting standard, which has bedeviled banks, faces scrutiny in 2021. U.S. accounting rulemakers signaled earlier in December that the accounting for what's called non-purchased credit deteriorated loans—purchased loans that haven't yet shown signs of distress—could be one of the first things they tackle. That's good news for bankers that sometimes refer to the accounting treatment as an acquisition tax.

Banks don't like the so-called double count "because it doesn't make sense," said John Lankenau, head of product and operations at SS&C Primatics, a software company that helps banks implement CECL. "Operationally, it's not terribly complicated," he said.

The CECL accounting standard went live for most large publicly traded banks in 2020. Privately held banks, credit unions, and some smaller public banks will follow the rules in 2023. The Financial Accounting Standards Board, which wrote the rules in the aftermath of the 2008 financial crisis, said it wants to work out the kinks before 2023.

Double Count

A central goal of the standard is to make banks and other businesses contemplate future losses every time they write a loan. Instead of booking losses when customers miss payments, businesses must record all reasonable future losses and set aside reserves to cover them. The new accounting methodology plus the uncertainty of the coronavirus pandemic made almost every bank's loan loss reserves soar.

The rules call for different accounting treatment for loans a bank buys depending on the health of the purchased loans. If a bank buys "purchased credit deteriorated" assets—loans that have already shown signs of distress—then it assumes that credit losses are built into what they paid for the loans. Healthy purchased loans should be booked as if the bank originated them. That means it has to record a reserve to cover future lifetime losses at the purchase date. Increasing loss reserves negatively affect the bank's net income as well as the capital it must hold under regulator requirements.

Technically, the "double count" is more like a one-and-a-half times count, which still stings, said Stephen Masterson, financial services lead for risk advisory services at Cherry Bekaert LLP. Another complaint is that it's difficult to draw the line between

CECL Arrives

The long, winding road to the biggest ever change to bank accounting – the Current Expected Credit Losses (or CECL) standard.

Source: FASB; Bloomberg Tax and Accounting research

what's a healthy versus an unhealthy purchased loan with the new rules, he said.

The "double count" accounting doesn't seem to have soured many deals so far. Several midsized banks announced acquisitions in 2020, including North Carolina-based First Citizens BancShares Inc. saying in October it would buy CIT Group Inc. in New York, and PNC Financial Services Group Inc. in November announcing that it would acquire BBVA USA Bancshares Inc., the U.S. arm of Spain's Banco Bilbao Vizcaya Argentaria.

But bankers still have to take time to explain the accounting to their investors.

"At the end of the day, it gives you an abundance of loss reserves," said Bryan Jordan, CEO of First Horizon Corp., at a Barclays Global Financial Services conference in September. In July, Tennessee-based First Horizon and IBERIABANK Corp. of Louisiana completed a merger.

Troubled Debt

Another issue tied to the new accounting standard has caused bankers and investors angst even though Congress and bank regulators sidelined it this year: troubled debt restructurings.

As the pandemic forced workers to stay home and businesses to shutter, banks wrestled with a wave of customer requests for loan breaks. Analyzing every request to determine if it qualified as a troubled debt restructuring under the new accounting would have been an onerous task, banks said. In March, regulators gave banks a temporary reprieve from the analysis for pandemic-affected borrowers. Congress followed later in March with the massive coronavirus relief bill (Public Law 116-136), allowing banks to skip the analysis until Dec. 31. In the latest relief package (H.R. 133), Congress extended that relief to Jan. 1, 2022.

Once a modification is labeled a troubled debt restructuring, it triggers separate presentation requirements and it means the bank has to set aside more reserves to cover potential losses. Banks expect the accounting to get ugly once the relief measures expire.

"Right now I'm in this purgatory, but at some point I'm either going to heaven or hell when this stuff lifts," Masterson said. "And I need to start planning for that now."

FASB appears ready to tackle this issue, too. At least one FASB member openly questioned whether separate requirements for troubled debt modifications makes sense when the accounting requirements weren't even in place during a time when customers asked for—and got—major forbearance help.

This argument resonates with bankers and many accountants, too. There is increasing momentum among bankers and accountants to get FASB to delete requirements for troubled debt restructurings, said Graham Dyer, partner in Grant Thornton LLP's accounting principles group.

"It makes you question how meaningful it is if every time there's going to be a bunch of them we say, 'Nah, just forget it,'" Dyer said.

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Biden Gets Prodded From Left on Tax Hikes That Now Look Unlikely

By Jarrell Dillard, Bloomberg News

December 16, 2020

- Tight balance of power in Congress limits room for maneuver
- House bills could set up debates for 2022 midterm elections

President-elect Joe Biden had one of the most progressive tax plans of any presidential platform, and activists are trying to make sure the momentum doesn't stop there.

But Biden won't have decisive Democratic majorities in the House and Senate to work with, making grand plans tough to enact. At best, Democrats could have only narrow control of both chambers, depending on Jan. 5 runoff elections for two Georgia Senate seats.

The challenge isn't deterring progressive groups, who argue that Biden has a mandate to enact proposals that the left wing of the Democratic party has been trying to make mainstream for years: taxing investment income the same as wages, putting a levy on offshore corporate profits and ending tax perks for assets the wealthy pass on to their heirs.

Frank Clemente, the head of Americans for Tax Fairness, said there's nevertheless an opening to change tax laws so that the wealthy and businesses pay more. His group is launching a pressure campaign on the incoming administration and Congress to follow through on the president-elect's pledge to raise taxes on the wealthy and on corporations.

"He stuck to his guns on tax issues. He took a lot of attacks, and didn't shy away from it," Clemente said. "He says himself he has a mandate."

The Biden transition team didn't immediately respond to a request to comment.

Revenue Estimates

Independent estimates say Biden's tax plan could raise anywhere from $2.4 trillion to as much as $5 trillion. But passing the laws necessary to pull in that level of additional revenue will be a huge challenge, especially in the Senate, where the best-case scenario for Democrats is 50 seats, with Kamala Harris breaking the tie as vice president.

Together with a slim House majority, having such narrow control would elevate the influence of centrist Democrats like Representatives Mikie Sherrill of New Jersey and Abigail Spanberger of Virginia, who represent districts critical to the party maintaining control.

"We remain hopeful about the possibility of a Senate majority, which would hold open the possibility of advancing tax fairness through reconciliation," Representative Don Beyer, a Virginia Democrat who is a member of the Congressional Progressive Caucus, said. "And if Republicans continue to feign the interest they have suddenly rediscovered in fiscal discipline, fair revenues are absolutely going to be part of that conversation."

Reconciliation is a fast-track process for budget-related legislation that could get through the Senate with just a simple majority, rather than the 60 votes needed to overcome a filibuster.

'Boldly Progressive'

Clemente says he's working with members of Congress and transition officials to turn Biden's campaign plan into legislation. He has outlined a 100-day tax agenda calling for a Biden White House to increase IRS enforcement, require presidential candidates to release their tax returns, and start rolling back tax preferences for wealthy individuals and businesses.

"Democrats can't lose sight of the fact that Biden ran on a really boldly progressive tax agenda and he won decisively by more than 7 million votes. And I think that's something we shouldn't forget," Seth Hanlon, a senior fellow at the left-leaning Center for American Progress, said. "Democrats have the public on their side."

Biden's plans concentrated the tax increases on those earning at least $400,000. Americans for Tax Fairness points to a November New York Times-Survey Monkey poll that shows raising taxes on that segment of the population is popular with 85% of Democrats, 70% of independents, and even 45% of Republicans.

There are some tax areas where Republicans and Democrats could find common ground, such as expanding the child tax credit. Republicans made that tax break more generous in their 2017 tax overhaul. Biden campaigned on further expanding the benefit.

"That's one where they could shake hands and agree," Gordon Gray, the director of fiscal policy at the right-leaning American Action Forum, said. "They can usually agree to borrow the difference."

'Real Problem'

Representative Judy Chu, a California Democrat, said she sees the possibility for agreement, pointing to existing bipartisan, progressive proposals that would "put money into the hands of those who need it, instead of relying on the completely debunked trickle-down theory."

Those ideas would make the tax code more progressive by lowering taxes at the bottom end of the income spectrum. But raising taxes – the centerpiece of Biden's and progressive Democrats' tax goals – remains elusive.

Keeping progressives happy while also finding a way to work with congressional Republicans is "going to be a real problem for Biden," said Brad Bannon, a Democratic strategist.

"With a small House majority, progressives have more leverage now," Bannon said. "They can easily sit out a vote and make Pelosi's life miserable."

Pelosi's Challenge

That creates an opening for House progressives to demand votes on major priorities ranging from taxes to climate change. Even if the bill is unlikely to advance in the Senate, progressives can ask for a House vote in exchange for supporting bills House Speaker Nancy Pelosi, the presumed top Democrat in the next Congress, wants to pass her chamber.

"That gives you something to run on," Clemente said. "You can say: I have a mandate. The Senate blocked it so we need a new Senate."

Democrats are confident that they can maintain public support even if their agenda in Congress is deadlocked. Just 27% of respondents to a 2019 Gallup survey said that high-income individuals pay their fair share in taxes, while 23% said that of corporations.

"Getting a tax agenda through Congress will be challenging in any scenario," Hanlon said. But Biden "and Democrats should put pressure on Republicans on these issues where the public is on their side," he said.

(Updates with poll on tax increase in the 12th paragraph)

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Photographer: Daniel Acker © 2020 Bloomberg Finance LP

Covid Relief Sets Up Nasty 'Reckoning' for Taxpayers Next Season

By Allyson Versprille, Lydia O'Neal, Reporter

December 22, 2020

- New 2020 virus tax measures to cause filing headaches
- Simply paying taxes owed will be a challenge for many

The upcoming tax filing season is poised to be more confusing and chaotic than normal, with tax professionals predicting Covid-19 relief measures will trigger surprise tax bills and costly filing mistakes.

Among the possible traps for taxpayers are undelivered portions of direct payments to individuals, enhanced unemployment benefits, and forgivable business loans under the Paycheck Protection Program.

Tax return preparers warn, for example, that many people have likely thrown away a key document for claiming the rest of their stimulus checks under the March CARES Act (Public Law 116-136) if they received too little from the IRS this year. Without the document, individuals risk entering incorrect information on their federal tax returns, possibly delaying the processing of those returns and any associated refunds.

"The reckoning's going to be very painful for a lot of people," especially for those also struggling to pay what they owe, said Dave Tolleth, president-elect of the National Association of Enrolled Agents.

Stimulus Checks

Direct payments from the CARES Act—$1,200 per individual, plus an extra $500 for each dependent under the age of 17—are advance credits against 2020 taxes. But in many cases, the payments already issued didn't reflect the amounts taxpayers qualify for.

Because Congress directed the IRS to use information from 2018 and 2019 tax returns to issue the payments quickly, the amounts don't take into account if someone's income fell this year or they had a new child.

Those eligible for higher payments can claim extra credit on their 2020 Form 1040.

To calculate what they're owed, however, individuals must know the exact amount they already received. That can be found on Notice 1444 mailed by the IRS shortly after the checks.

But most people likely didn't realize the importance of the notice and tossed it, tax professionals said. For that reason, some have asked the IRS to create a portal to look the payments up online so that taxpayers don't have to sift through bank records or take other actions to track them down.

Putting an incorrect number on the Form 1040 could delay the processing of a return and any associated refunds. For many

Top 20 States Where Virus Relief Checks Went

The IRS in total distributed 160 million payments to Americans, worth about $270 billion.

State	Number Distributed	Total Cash Value
California	18.0M	$29.3B
Texas	13.1M	22.6B
Florida	11.2M	18.3B
New York	9.9M	15.7B
Pennsylvania	6.6M	11.0B
Ohio	6.1M	10.2B
Illinois	6.0M	10.0B
North Carolina	5.1M	8.6B
Michigan	5.1M	8.6B
Georgia	5.1M	8.5B
New Jersey	4.2M	6.8B
Virginia	4.0M	6.7B
Washington	3.6M	6.1B
Tennessee	3.5M	5.9B
Arizona	3.4M	5.8B
Indiana	3.3M	5.8B
Missouri	3.1M	5.3B
Massachusetts	3.3M	5.2B
Wisconsin	2.9M	5.1B
Minnesota	2.7M	4.7B

Source: IRS
*Data as of Aug. 28, 2020

Americans, those refunds are "the largest payday of the year," said Mark Steber, chief tax officer at the tax preparation firm Jackson Hewitt.

An IRS official at an event in October said the agency didn't have any plans for such a search tool but that it would consider it ahead of the filing season. More recently, the IRS told Bloomberg Tax: "We're continuing to review the situation."

'Surprise' Taxes

Individuals who received unemployment benefits, especially for the first time, might not realize that money is taxable, or that they could have opted for some of it to be withheld to cover part or all of their eventual tax liability.

"We're concerned that some people may get caught by the surprise of owing income tax on their unemployment income," said Kathy Pickering, the chief tax officer at H&R Block Inc.

An IRS spokesperson, when asked about how the agency is raising awareness of unemployment compensation taxes, cited an August news release, and "COVID Tax Tips" from August and September.

Working From Home

Taxpayers who worked remotely in a state or locality different from where they normally work may have to deal with W-2s that don't reflect their true situation, Pickering said. Employers file Form W-2 to report the wages, tips, and other compensation paid to employees as well as federal, state, and local taxes withheld from their paychecks.

Some individuals may be owed a refund for state and local taxes withheld for the wrong jurisdiction or face new tax liabilities where they moved, Pickering said.

Many newly remote workers might make the mistake of assuming they're eligible for a home-office deduction. But the tax break doesn't apply to full-time employees who receive a paycheck or a W-2 exclusively from an employer, Pickering said.

The work-from-home issues are constantly evolving, both on the federal and state levels, she noted, advising taxpayers to stay informed and keep good records.

PPP Loans, Deductions

Loans provided under the new Paycheck Protection Program are likely to be a "bookkeeping nightmare" for businesses and their tax return preparers, said Rhonda Collins, director of tax content and government relations for the National Association of Tax Professionals. Preparers will have to consider how clients accounted for the funds and ensure they didn't double count expenses in their financial statements before beginning work on returns.

The loans, which are eligible for tax-free forgiveness if used to cover certain expenses, may lead to unplanned tax consequences and difficulty determining certain credits and deductions.

Since businesses aren't taxed on the forgiven loan amount, they can't deduct expenses paid by the loans—even if they haven't yet filed for or received forgiveness, the IRS said in guidance released last month. If they have a "reasonable expectation" that the loan will be forgiven in the future, the deductions have to stop.

Losing those deductions increases a business's taxable income, which means a higher overall tax bill. But it can also complicate calculations of other credits and deductions, including a new 20% write-off for pass-through businesses, said Annette Nellen, a CPA and director of San Jose State University's graduate tax program.

Taxpayers and advisers who assumed—prior to the IRS's latest guidance—that they could continue deducting expenses until their PPP loans were forgiven will have to adjust their positions when filing next year.

But the ground may shift again before year-end, warned Robert Lickwar, a partner at CPA firm UHY LLP in Farmington, Conn.

Democratic and Republican lawmakers have both opposed the IRS's stance and signaled that they may allow for the expenses to be deducted under a forthcoming stimulus package. A bipartisan proposal unveiled earlier this week would do just that. Preparers, however, can't base returns on the hope or expectation that the IRS's policy will be reversed, Lickwar said.

Businesses will likely seek filing extensions if the issue isn't resolved by the time they have to submit a return next year, he said. Extensions, though, don't apply to the actual payment of tax—an estimate of which will still be due by the original deadline.

"It's kind of a mess, for sure," he said.

With assistance from Sony Kassam.

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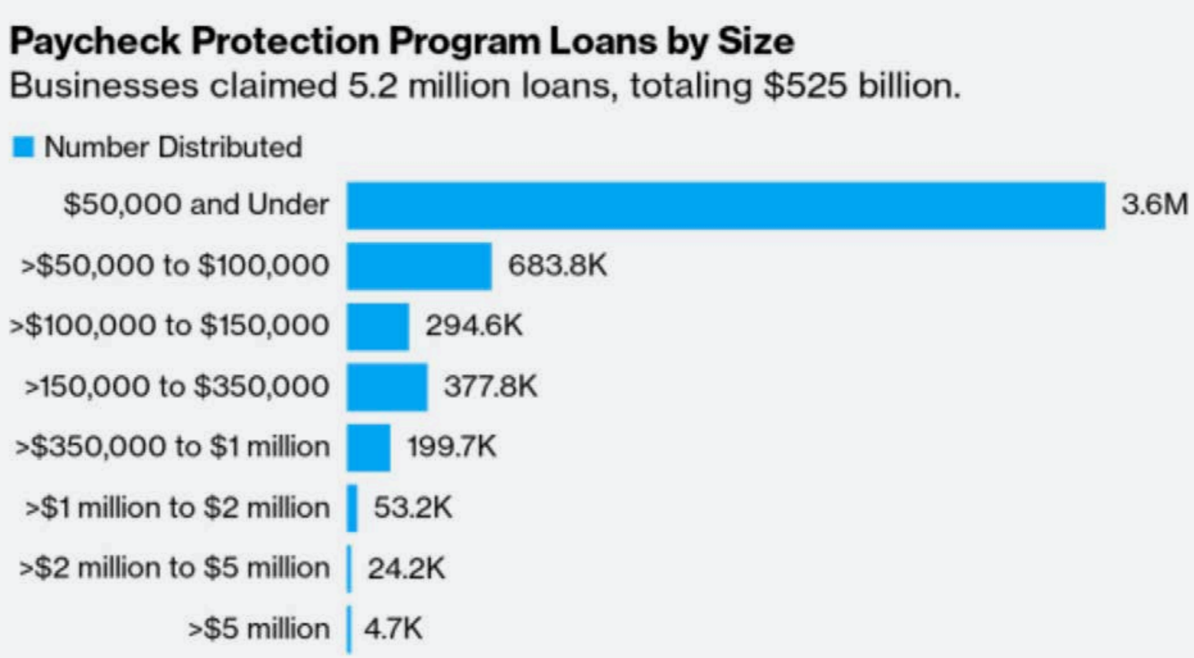

Source: Small Business Administration

High-profile tax disputes to watch next year include those between the IRS and multinational companies.
Photographer: Gabby Jones/Bloomberg

Facebook's Bill, Land Deals Among Looming Legal Tax Fights

By Aysha Bagchi, Jeffery Leon, Bloomberg Tax
December 30, 2020

- Much-watched cases at U.S. Supreme Court, appeals courts
- SALT cap, intercompany transactions among cases at issue

Litigation with billions of dollars at stake for Facebook Inc. and Coca-Cola Co. and a Supreme Court ruling on challenging tax rules are among the legal cases to watch in 2021.

Court watchers are also following a series of cases testing provisions and regulations tied to the 2017 tax law. The outcome of those battles could shape how Treasury approaches tax rules in the future, particularly when it comes to whether its rule-writing complies with procedural requirements under the Administrative Procedure Act.

"It is very much on the minds of practitioners that, from an Administrative Procedure Act perspective, there is fertile ground for challenging Treasury," said Stu Bassin, founder of the Bassin Law Firm PLLC and former Justice Department Tax Division litigator.

Here are the tax cases to watch over the next year:

Coke, Facebook Billions at Stake

In June, the U.S. Tax Court trial will resume between Facebook and the IRS in a case, *Facebook v. Commissioner*, concerning $1.73 million in taxes on intangible assets, including trademarks and technology, that the company transferred to its Irish office. A win for the IRS could cost the social media giant nearly $9 billion in taxes, interest, and penalties.

Officials at the Organization for Economic Cooperation and Development and within the European Union are closely watching the case as they grapple with guidelines for how companies should value intercompany transactions involving certain intangible property, said Irina Pisareva, partner at Sullivan & Worcester LLP.

Several tax attorneys said they are expecting Coca-Cola to appeal a Tax Court opinion saying the company owes the bulk of a $3.4 billion tax bill linked to its multinational operations. Coca-Cola said at the time of the opinion that it was considering the "potential grounds for its appeal," and declined on Dec. 16 to comment further.

Justices to Weigh In on Tax Rules

The U.S. Supreme Court is expected to rule in *CIC Services v. IRS*, which could significantly impact tax enforcement.

The consulting firm wants a court to consider its challenge against a penalty-backed reporting requirement, but it has been twice blocked by the Anti-Injunction Act, which generally prohibits lawsuits aimed at restraining tax assessment or collection.

High Court Considering Right to Fight Tax Rules
Ruling in case challenging IRS notice could shape future agency battles

Date	Development
May 2017	CIC Services files lawsuit challenging IRS Notice
Nov. 2017	U.S. District Court for the Eastern District of Tennessee rules for IRS
May 2019	Sixth Circuit rules 2-1 in favor of the IRS
May 2020	Supreme Court announces it will hear case
Dec. 2020	Oral arguments held at Supreme Court

The justices questioned the IRS in Dec. 1 oral arguments, with some suggesting that the firm may have no way to get judicial review without risking criminal exposure. A win for CIC Services would allow taxpayers to challenge other third-party reporting requirements.

"While the ruling may have limited applicability, it will address an important concern with how the IRS labels transactions subject to burdensome reporting requirements without warning, and without notice to and comment from taxpayers that are impacted by the IRS designations," said Charles Ruchelman, a member at Caplin & Drysdale specializing in tax controversy.

Fighting the 2017 Tax Law

Multiple lawsuits challenging international provisions of the 2017 tax law and related regulations are set to unfold in the new year.

Developments are expected in *Liberty Global, Inc. v. United States*, a lawsuit claiming that Treasury owes the telecommunications company $109 million after issuing temporary rules that allegedly exceeded the department's authority. The rules (T.D. 9865) relate to a foreign-dividend deduction under tax code Section 245A.

Several cases—including *FedEx Corp. v. United States* and *Silver v. IRS*—challenge regulations over a Section 965 levy that applies to the untaxed foreign earnings of U.S. shareholders

Lawsuits Centering on 2017 Tax Law Provisions
International tax issues emerge as major focus of court fights

Case Name	Focus of Challenge	Code Section
Liberty Global, Inc. v. United States	Temporary regulations on foreign-divided deduction	245A
FedEx Corp. v. United States	Portion of transition tax rules affecting foreign tax credit	965
Silver v. IRS	Transition tax rules	965
Moore v. United States	Constitutionality of transition tax	965

Photographer: Stefani Reynolds © 2020 Bloomberg Finance LP

of certain foreign corporations, treating the earnings as if they were brought back to the U.S.

And a January appeal is possible in *Moore v. United States* after a federal court dismissed a couple's constitutional challenge to the transition tax.

Read This Next: Portfolio, BNA Pick, Additional Analysis on Transition Tax (*Bloomberg Tax Subscription*)

SALT Litigation

An appeals court ruling is expected in *New York v. Mnuchin* over the constitutionality of the 2017 tax law's SALT cap, which limited individual federal deductions for state and local tax payments to $10,000. New York, New Jersey, Connecticut, and Maryland faced skeptical judges in December as they asked the U.S. Court of Appeals for the Second Circuit to reverse a lower court's ruling upholding the cap.

Meanwhile, New York, New Jersey, and Connecticut have asked a New York federal court to hold oral arguments in *New Jersey v. Mnuchin*, which is challenging IRS rules trying to block state workarounds of the limit.

Read This Next: Portfolio, BNA Pick, Additional Analysis on SALT Deduction (*Bloomberg Tax Subscription*)

Conservation Easements

Litigation over conservation easements—which involve donating the right to develop land for preservation purposes—will continue to unfold. The transactions can generate a tax deduction if the tax code's rules are followed.

The area is a high enforcement priority for the IRS and also one where it saw frequent wins this year.

Cases before two appeals courts—*Oakbrook Land Holdings, LLC v. Commissioner* at the U.S. Court of Appeals for the Sixth Circuit, and *Hewitt v. Commissioner* at the Eleventh Circuit—test rules governing those charitable contribution deductions.

The Tax Court will again be addressing the validity of two easement deductions in *Pine Mountain Preserve, LLP v. Commissioner* after the Eleventh Circuit tossed out an earlier ruling that had disallowed the deductions.

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Photographer: Brent Lewin © 2014 Bloomberg Finance LP

Taxing Tech Giants on Cash-Strapped States' Agendas in New Year

By Michael J. Bologna, Bloomberg Law

December 28, 2020

- States consider tax reforms allowing levies on e-commerce
- Potential new tax duties for Big Tech and its consumers

Taxing features of the digital economy will be a high priority in many states next year with legislatures expected to modernize their tax codes and capture new revenue to replenish their pandemic-wounded budgets.

Lawmakers are preparing to file bills from Florida to Washington, patching up holes in their tax systems that prevent levies on e-commerce, online marketplaces, and streaming services. And some states, including Maryland and New York, could make history by enacting the first laws capturing a slice of the digital advertising revenue collected by social media, search engine, and streaming services companies.

The spate of proposals could mean higher tax bills for tech titans Amazon, Apple, Facebook, Google, Microsoft, and Netflix, in addition to the millions of consumers using their services.

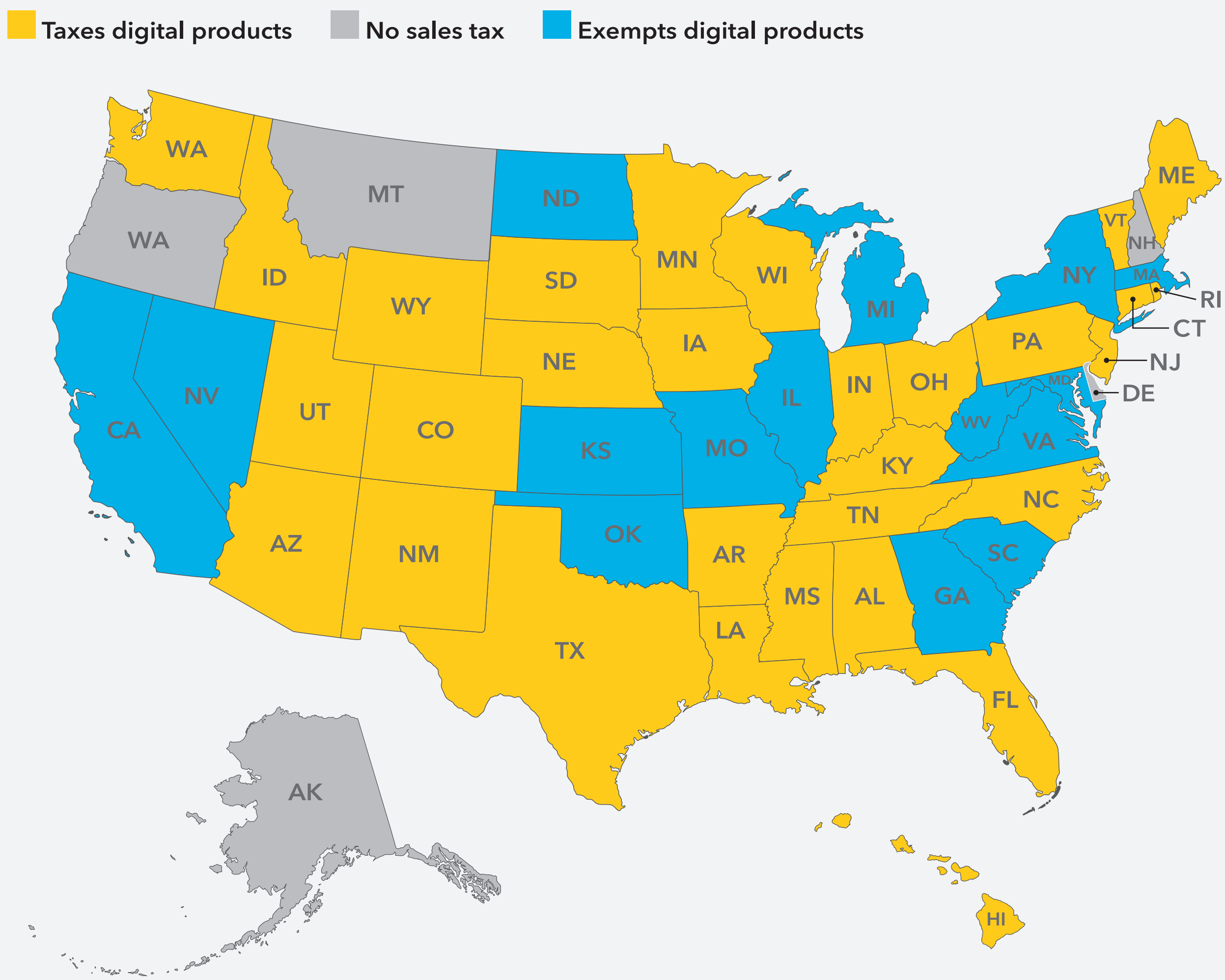
Agencies will next year push more to tax tech companies "in ways that achieve parity with the traditional goods and services economy," said Carl Davis, director of research at the Institute on Taxation and Economic Policy. "The sales tax laws are generally lagging behind," he said.

Covid-19 revenue losses have forced states to seek new revenue sources. The hard shift to online shopping and streaming services, exacerbated by the pandemic, has revealed how existing tax systems leave out swaths of the digital economy.

The path won't be easy because digital products and services don't fit neatly into existing state tax structures. To capture the revenue potential from streaming services, digitally delivered software, and online advertising, states must be patient, thorough, and willing to defend their strategies against legal challenges from the digital behemoths, according to tax administrators and lobbyists interviewed.

"New business models are called economic disrupters for a reason, they're disruptive," said Verenda Smith, deputy director of the Federation of Tax Administrators. "They're young and fluid, and existing tax structures are absolute and hardly nimble. That's a recipe for unhappiness and complaints."

Many States Decline to Tax Digital Products and Services



Digital Goods & Services

States and municipalities may choose to overhaul their sales tax codes to go after revenue from digital goods and services, particularly as jurisdictions incur tax and fee losses resulting from consumers cutting the cord on traditional entertainment platforms, said Steve Lacoff, general manager for communications taxes at Avalara. States and municipalities are "poor" and continue to "lose money at an accelerating pace due to cord cutting" from cable companies, Lacoff said. He noted some states have recently sued Netflix, Hulu, and other streaming entertainment companies to collect unpaid local utility franchise fees.

The shift could be as prominent as the taxation changes states enacted following the 2018 U.S. Supreme Court ruling in *South Dakota v. Wayfair*, Lacoff said. The groundbreaking 2018 decision allowed states to impose tax collection duties on remote e-commerce retailers based on economic activity in a state rather than physical presence.

Most tax codes were crafted to tax tangible personal property, leaving digital versions of books, records, movies, software, and games untaxed. Thirty states and the District of Columbia have expanded their tax bases to include some digital products, but 20 states don't tax any online products.

"Differing versions of this type of legislation addressing digital goods and services have been proposed over the last several years and I would expect something similar to again resurface during the upcoming 2021 legislative session," said Jonathan Feldman, a tax partner in the Atlanta offices of Eversheds Sutherland LLP.

Maryland could be the first state to address the taxation gap as Democrats, with a veto-proof majority in the state legislature, try to override Gov. Larry Hogan's (R) veto of H.B. 932, said Delegate Eric G. Luedtke (D). The bill would apply the 6% sales and use tax to digital products, such as music and e-books.

Other states where action is possible include Georgia and Missouri.

In Georgia, H.B. 1056 would apply state sales tax to most digital products. The bill didn't advance this year due to a shortened legislative session, but the change could generate $100 million for the state and $83 million for municipalities beginning in 2022, according to analysis by Georgia State University.

A Missouri bill, H.B. 244, would bring the state into compliance with the *Wayfair* principles and require sellers to collect taxes on digital goods and services. The measure was prefiled for potential action during the 2021 legislative session.

Digital Advertising Tax

States are also eyeing the $124.6 billion earned last year by search engine, social media, and streaming companies from online advertisements. And, as much as $14 billion annually is lost because of state tax codes that leave revenue from online ads untaxed, estimates University of Tennessee economist Bill Fox.

"No state that I know of has a digital advertising tax or a digital services tax that is like the ones being proposed in a good handful of states," said Charles Maniace, vice president of regulatory analysis at the tax software company Sovos. Digital ads are "an untapped source" of revenue, he said

Maryland, New York, Nebraska, West Virginia, Washington, and the District of Columbia all considered bills this year that either bring digital advertising into the sales tax code or impose a gross receipts tax on the revenue of large tech companies.

Maryland made the greatest progress, passing a bill (H.B. 732) taxing the gross receipts of tech companies earning more than $100 million annually. Hogan vetoed this measure as well, but Leudtke said it passed by veto-proof majorities and would likely be overridden early next year just like H.B. 932.

Taxes on digital advertising still have a difficult path ahead. The strategy could face challenges on constitutional grounds, legal scholars say. It also faces immense opposition from the tech industry, which has vigorously opposed digital advertising taxes in state capitols across the country. Google's chief of state legislative affairs Ron Barnes emphasized the legal issues in a letter to the Maryland legislature, pointing to potential violations of the Permanent Internet Tax Freedom Act and the commerce clause of the Constitution.

"There are enormous political obstacles to enacting any of these things because you're talking about taxing the sources of the most concentrated wealth and power in the country," said Dan Bucks, former director of the Multistate Tax Commission.

With assistance from Tripp Baltz in Denver.

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INSIGHT

Going into Winter? Tax and Digitalization in 2021

By Will Morris, PwC

December 28, 2020

Substantive progress on tax and digitalization faces many obstacles and doesn't look promising as we enter 2021. Will Morris examines the challenges, considers the possible outcomes, and concludes that a workable (and improvable) multilateral agreement is preferable to a free-for-all of DSTs, tariffs, and revenue grabs.

In a cold December, at the end of this pandemic year, T. S. Eliot's 1927 poem, *The Journey of the Magi*, seems a most appropriate summation of—or, perhaps, epitaph for—2020. But focusing in on the tax world, for a journey that started so promisingly almost four years ago, the OECD secretariat in Boulogne-Billancourt in Paris might also be forgiven for thinking that Eliot had them particularly in mind—at the end of this disrupted year, with disagreements on full view, the OECD's digitalization project is certainly having a "cold coming of it".

So, is it all over? Should the project be allowed to collapse and die, buried in a blizzard of political disagreements and unfavorable comments? I don't think so. While I do believe some aspects of the project are in serious trouble, and that some significant changes are needed, I keep coming back to two basic, absolutely fundamental points. First, there is a genuine, significant and growing international tax issue about the "remote" creation of value/profit that needs to be solved. Second, in almost any circumstance, governments, citizens, and businesses will be better off with a comprehensive, **principled** multilateral solution to that issue than they will be if countries act unilaterally, fashioning solutions that are uncoordinated and each engineered to advantage that country (whether or not to the detriment of others).

"A cold coming we had of it,
Just the worst time of the year
For a journey, and such a long journey:
The ways deep and the weather sharp,
The very dead of winter."

So, having said that, let me first briefly lay out some of the major problems, and then consider how/if they might be solved at a multilateral level.

Pillar 1, Amount A

- Disagreements over scope: Should this scope be "narrow" digital, or broader Automated Digital Services (ADS)? Consumer Facing Businesses as well? All businesses above a certain profit margin?
- More specific disagreements over the inclusion or exclusion of certain sectors and sub-sectors, including substantial industries such as Pharma.
- The Arm's-Length Standard (ALS): to what extent does it survive/operate in this proposal?
- Segmentation: how scientific and focused does this need to be? Can a business rely on its own financial reporting segmentation? What about when business has lines that are in, and others that are out, all in the same reporting segment? Is regional segmentation going to be respected?
- Countries/businesses "bearing" taxes, and allocation of taxes to other jurisdictions. There are countless landmines here, as tax revenue (i.e., the money governments spend …) is at stake. Does there have to be a business presence and substance connection with the country to which taxes are reallocated?
- How are losses dealt with? Where can they be offset? How are they carried forward? This again is a key issue not just for businesses but also for countries.

Pillar 1, Amount B

- There are fundamental disagreements over scope (just basic marketing and distribution functions, or a much more extensive—and high value—range of activities?). The split, largely, but not entirely, comes down to developed "residence" countries vs. less developed (LDC) "source" and "market" countries, with the developed countries wanting a narrower scope and a much lower fixed return, and the LDCs wanting a broader scope and a correspondingly higher fixed return.
- There are significant questions about how to limit the impact of Amount A, if a business is also subject to Amount B (i.e., in-scope activities, as well as a physical presence). And what should be done with respect to the interaction of Amount B and withholding taxes? While Amount A is clearly not meant to reflect the ALS, Amount B is meant to approximate it—but if it is a fixed percentage of profit, for example, then for a high-margin business Amount B could considerably exceed the ALS amount for those functions.

Pillar 1, Dispute Resolution

- How is the dispute resolution mechanism going to function? While the Amount A review and determination panels procedure is truly innovative, it is unclear whether tax authority resources are realistically available to make the process work even with an initial threshold of $5bn of global revenue. According to the Pillar 1 Blueprint, that's still 620 major Multinational Enterprise (MNE) groups involved.
- Because of the objections of some of the BRICS and many LDCs, mandatory binding arbitration—which was viewed as one of the biggest potential benefits for business (and their home country governments)—has not been included in the blueprints.

Pillar 2

- For both the U.S. government and the U.S. business community, the overwhelming Pillar 2 issue is how comprehensive the exclusion from the Pillar 2 rules will be if GILTI is agreed to be a compliant Pillar 2 regime.
- If that exclusion is not comprehensive, then issues arise around the calculation of per-jurisdiction Effective Tax Rates (ETRs); the calculation of Profit Before Tax (PBT) and the need for a separate system for taking account of timing differences, etc. The result could be a **very** substantial compliance burden, not to mention disputes between countries.
- What is the impact on certain national incentive regimes for, e.g., innovation?
- There are issues around the priority of the Subject to Tax Rule over the Income Inclusion Rule, and the application of that rule to items (or streams) of income (even narrower than the per-country ETR).
- There is the question of how to ensure uniformity on both rates and implementation when countries will likely individually enact these measures in national legislation. This relates partly to the issue of complexity above (and the doubts already expressed by some countries about their ability to administer a system of this complexity), but also what overall governance structures might be.

When you look at these significant problems, you must also remember that 137 countries (many with very different interests) are involved, understand that the next 6 months will still be interrupted by Covid, remember that an incoming U.S. Administration will likely not be fully in place before March or April, and recall that the EU is committed to coming forward with proposals on a digital tax by June. Truly, it seems that the project is having "a cold coming … of it."

So, should I predict the demise of the project – both Pillars 1 and 2, as they do seem to be politically linked? Well, it is a real possibility. However, if that happens what will have really died is not "any action," but the possibility of "multilateral action." There will be no reversion to the status quo ante. Instead, the future will be full of DSTs, unilateral attempts to impose destination-based taxes, and further tax base protection measures based on deduction denial/BEAT models. That would be a **very** bad outcome. That bad outcome, of itself, may not be a reason to sign up to the current, rather troubled, version of the project—but it is surely a reason to seriously work on reimagining the project. How? Well, let's go back through some of the problem areas and see what might be possible.

Amount A. The biggest problem with Amount A is the lack of a clearly articulated reason for reallocating income to market countries, and without that principle Amount A has become subject to significant horse trading. On subsidiary, specific issues I think that the current scope is an almost insoluble one at this point. The nexus rules, however, will have to change one way or another. Segmentation just seems destined to become ever more complex. And the dispute prevention and resolution procedures could be overwhelmed.

So, what might be done? Well, first, perhaps, there needs to be an acknowledgment that this is fundamentally an argument about "winners" and "losers" under the current system that can only ultimately be resolved by a full, open and honest discussion about the current balance of source taxation (and now also market/destination taxation) vs. residence taxation. This subject does need to be seriously opened up if stability is ever to be restored—but will also take longer to resolve than the next six months.

To get this project back on its feet in the short term, however, some type of narrowing of scope is required. To start that narrowing, a more modest articulation of the issue might help: the need to find a principled method for taxing the remote creation of value/profit not covered by current rules under physical presence tests. Further narrowing could take place by changing the thresholds, perhaps by way of phasing the rules in. To solve the political issue of DSTs, perhaps Amount A offsetting any DST could be reconsidered. Alternatively, something around introducing a net element into DSTs might work (both to apply it more equitably to net income, as well as making it creditable).

The time crunch issue will require the new US Administration to prioritize this (among a host of such issues …), and reach out swiftly to the Congress—and the G20 is likely to make the importance of this known to the new administration very quickly. But, while it would be very difficult for the U.S. to go back on not "ringfencing the digital economy," refocusing any reallocation provision on a principled, proportionate, and manageable application to businesses that create value remotely (not just "tech") is not impossible.

Amount B. Given the entrenched position of both sides, more time is needed to reach a meaningful agreement. That time could be bought by the idea raised by the OECD themselves of a pilot program.

Dispute resolution. A narrowing of Amount A would have the added advantage of reducing pressure on the dispute panels, and give them time to get up-and-running so as to find a rhythm.

Pillar 2. There is no doubt in my mind that if the OECD does not reach a Pillar 2 agreement, then the EU will pick up something pretty similar and seek to embody it in a directive. As a result, whether or not there is an OECD agreement, in order to avoid a potential compliance and administrative crunch for both taxpayers and tax authorities down the road, it will be important over the next six months to work on ways to simplify this provision. I think the desire is there for that among governments, but it will require some give-and-take around whitelists, or safe harbors based on easily ascertainable numbers rather than complex new calculations. Additionally, issues around PBT and tax base calculation and interaction with accounting rules will need to be considerably refined, but, again, I think the will exists there.

It is, obviously, very difficult right now to predict how the project will go next year. But failure is a real possibility—and that failure will bring serious consequences. Complex—and not always internally consistent—though the ideas in the Blueprints may seem, they cannot now be un-imagined. And a good, or at least workable (and improvable) multilateral agreement, is much preferable to the free-for-all of DSTs, tariffs, revenue grabs, and mounting disputes that would otherwise follow. It's still worth working for, because if you think it looks like winter in the international tax world right now, just wait …

Author Information

Will Morris is PwC's Deputy Global Tax Policy Leader and Chair of the Taxation and Fiscal Committee of Business at OECD (BIAC). However, the views expressed in this article are personal, and do not necessarily represent the views of either PwC or Business at OECD.

Photographer: Daniel Acker © 2020 Bloomberg Finance LP

A cargo ship docked near the Evergreen Marine Corp. shipping terminal at the Port of Los Angeles.

Photographer: Bing Guan/Bloomberg

INSIGHT

Tax Scrutiny and Transfer Pricing: What You Can Expect in 2021

By Mimi Song, CrossBorder Solutions

December 23, 2020

Covid-19 disrupted and further complicated the never-simple world of transfer pricing. Mimi Song of CrossBorder Solutions outlines what tax departments need to do to prepare for scrutiny by tax authorities hoping to squeeze revenue out of transfer pricing in 2021.

Tax scrutiny is hardly new to the world of transfer pricing. In the last few years, tax authorities have taken a fine-tooth-comb approach to multinational enterprises' (MNEs) transfer pricing documentation, routinely questioning the finer points of where and how profits land among entities. Although by now, multinational companies have grown accustomed to conducting intercompany transactions under hawkish revenue officers, most haven't experienced the kind of aggressive tax surveillance that is expected in 2021.

Between government-appointed shutdowns, supply-chain disruptions, and falling demand in products and services, Covid-19 has shocked global value chains as violently as it has countries and their infrastructures. Unemployment has increased. MNEs have postponed investments plans. Liquidity issues have buried companies in debt and losses. And tax authorities haven't fared much better. Government relief programs—guarantees, tax holidays, subsidies, and 2020 audit respites—are costly, and tax authorities will need to recover revenue lost to Covid-19 support, as well as from decreased taxable income. The OECD's Tax Policy Reform 2020 discusses the importance of tax policy to "restore public finances in a fair and sustainable way after the crisis." Transfer pricing, a somewhat subjective vehicle for allocating group profits and losses, is an obvious place to do it.

Most of us have never experienced a global pandemic, but we have certainly lived through depressed economic times—and for transfer pricing experts, there's much to learn from them. In 2009, the IMF noted the effects of 2008's Great

Recession—a tax gap created by bankruptcies and loss-ridden companies, which, thanks to understaffed tax departments and limited resources, led to non-compliance. Fast-forward to 2021 and tax authorities will be expecting a replay of weakened efforts by MNEs to comply with transfer pricing regulations, positioning tax authorities on the offensive even more.

Well before the pandemic and the need to recover Covid-relief revenue, tax authorities had been vocal about stepping up transfer pricing audit resources and homing in on cross-border transactions. Covid-19, however, has intensified those efforts. Many countries that had put transfer pricing audits on hold as a form of economic support, have already resumed them—even with the pandemic still going strong. The National Tax Agency of Japan, for example, has strengthened its transfer pricing audit program, taking a risk-based approach and bundling transfer pricing examinations as part of corporate income tax audits, making more taxpayers susceptible to transfer pricing microscopes. Not surprising, the country has already ended its audit hiatus.

The U.K.'s HM Revenue & Customs (HMRC) had also suspended transfer pricing investigations due to the coronavirus. But in September, HMRC relaunched them by sending letters asking certain multinational companies how confident they were that their transfer pricing was "appropriate." *The Financial Times* recently reported HMRC also announced that 2,000 of the largest businesses in the U.K. may owe an additional $42.3 billion (34.8 billion euros) in tax, claiming that local profits don't accurately represent the value created in the U.K.

While tax authorities around the globe may be on the transfer pricing hunt, they're still aware that losses may be justified due to 2020's extraordinary circumstances. After all, Covid-19 has been as much an economic virus as it has been a respiratory one. The question is where should those losses fall? Revenue officers will argue that lost tax dollars should remain outside their jurisdictions, leaving MNEs on the defensive and prone to exorbitant transfer pricing adjustments, and double taxation. Now more than ever, it's important for multinational companies to be proactive about transfer pricing, and diligent documentation is key—especially given tax authorities' expectations of non-compliance. MNEs may find they need to go beyond traditional approaches to economic analyses in defense of their arm's-length positions. The following strategies, geared specifically for 2020 documentation, promise to help reduce the risk of audit in extraordinary times.

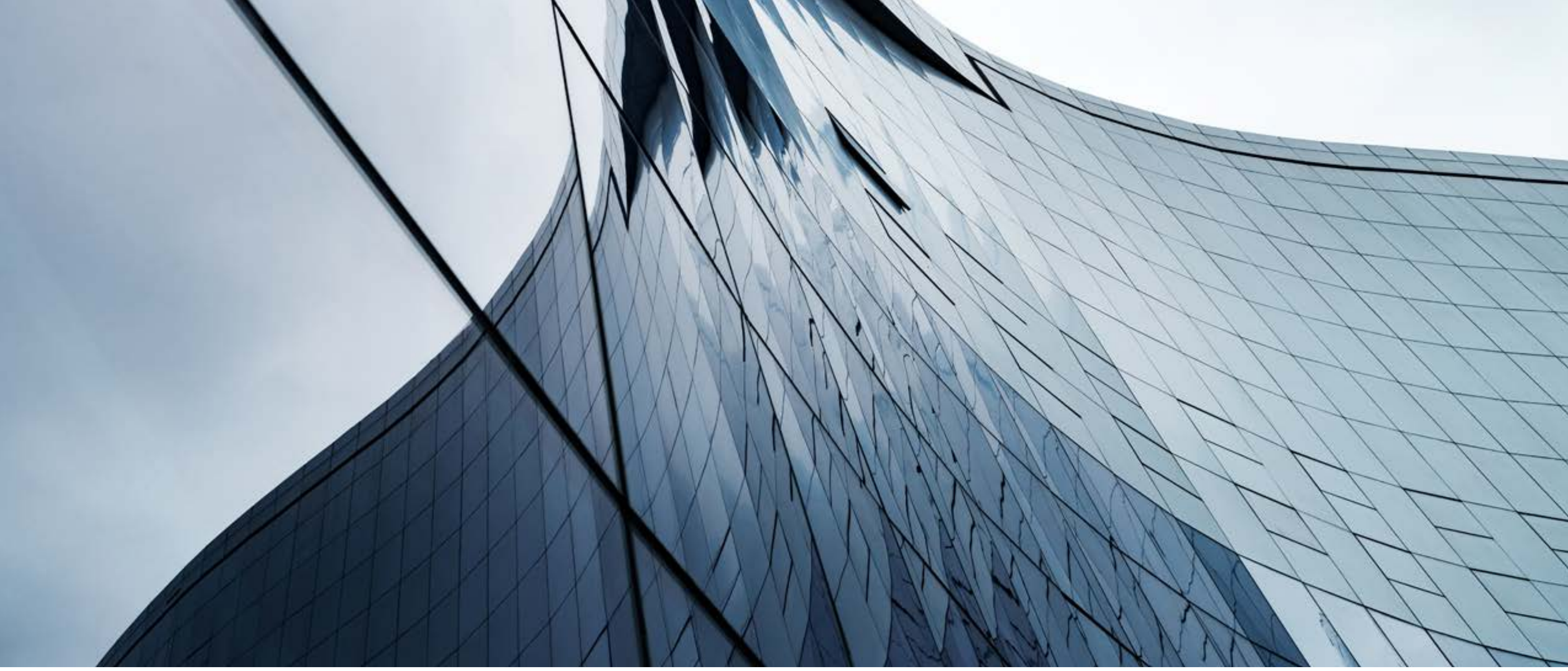
Pay Extra Attention to Benchmarking

It's no secret that the Coronavirus continues to affect industries and individual companies differently. The problem that presents for transfer pricing is that every transaction is based on the arm's-length standard, which is determined by comparing intercompany transactions to third parties. If those third parties haven't been affected in the same way as the tested party, there goes the arm's-length range. Redoing a comparable search may not solve the problem (though it's still worth trying), thanks to the lag time between a fiscal year and when an MNE's information is available on public databases. In fact, if conducting a traditional benchmarking analysis, MNEs may find themselves with an overall shortage of comparable companies, and therefore, a vulnerable arm's-length range.

Tax authorities, of course, are on to this, and they'll be taking a hard look at 2020 benchmarking analyses, lending a close eye to misaligned comparables. So, transfer pricing experts will want to explore every avenue to prove that comparable companies are, in fact, still comparable. Here are a few strategies to consider:

Embrace the past

Covid-19 has created such extraordinary circumstances that comparables from 2017-2019, which were not affected by the virus, might not be relevant. Consider including comparable transactions from past years that also endured economic hardship. Data from times of economic downturns or recessions may present stronger comparability to the tested party. Of course, you'll have to explain the market changes that took place between now and then, and why, given 2020's extraordinary circumstances, it was necessary to turn back the clock.



Include Companies in Loss Positions in Your Comparable Set

Granted, normally, tax authorities aren't fond of including start-up companies or those in the red as part of a comparable set. But then, there's nothing normal about 2020. Fair market prices should reflect actual market conditions, and companies in a loss position may demonstrate 2020's reality best. So, think outside the box. Can you play with the maximum number of years that a company can show losses? What about the size of the losses themselves? Have you justified loss inclusions in the application of the economic analysis? The goal is to represent actual market conditions to uphold the reliability of your comparable companies, and you may require a little flexibility to do it.

Look to Comparables in Similar Markets

Yes, some countries—most of them, in fact—mandate local comparables, which can be tricky in the best of times as they may or may not exist. Now, however local comparables become even more complicated because Covid-19 has uniquely impacted each country. For example, local market conditions may be impacted by government support. While the benchmarking should continue to focus on local comparables—expanding beyond the country may be necessary to corroborate differing economic impacts on a transfer pricing analysis. But be sure to explain how and why foreign comparables provide a corroborating analysis that might better align with the conditions of the tested party's market.

Define Covid-19 Costs for Your Business

In the last year, multinational companies have been forced to buy masks, gloves, plexiglass dividers, and hand sanitizers, among other products, just to keep their businesses going. Some have retrofitted office or factory space, and many have paid for routine deep-cleaning services and maybe even air-filtration systems. And while no one questions why these supplies are suddenly necessary, accountants may wonder, 'where will they be listed on corporate P&Ls?' Some companies characterize such expenses as one-time costs, claiming they'll disappear once a vaccine arrives—but in the meantime, the characterization is inflating non-GAAP earnings. Now three quarters into the pandemic and many experts think Covid-19-related costs belong under the usual costs of doing business and so, will have no effect on non-GAAP earnings. After all, who knows how long such expenses will be necessary? Either way, the judgment call has implications for transfer pricing.

Along with costs, expenses will need consideration, as well. Tax policy changes, as a result of government stimulus packages, such as the CARES Act Paycheck Protection Program, have transfer pricing implications of their own. For example, the IRS has indicated that payment of expenses covered by a forgiven PPP loan will no longer be deductible, which begs the question, should these expenses be captured as reimbursable intercompany charges if they are not deducted locally? In terms of transfer pricing, the treatment of costs and expenses could be challenged since they impact profit-level indicators, as inconsistencies will lead to unreliable results. Complicating things more is the treatment of costs and expenses by comparable third parties, creating vulnerabilities with the benchmarks. Be sure to see where Covid-19 costs are booked by independent third parties to determine true comparable companies and make sure to align your accounting or apply adjustments accordingly, so the reliability of benchmarks cannot be challenged.

Revisit Transfer Pricing Policies

For many MNEs, the pandemic has affected financials, business models, and supply chains, and every group will need to take stock of how the business has changed and make sure it's reflected in the transfer pricing policy. The goal is to be sure the policy reflects the company's present or future economic reality—not the past. Functions and risks may have found new homes in the supply chain. Royalty or interest payments may be on hiatus, and financial relationships may have changed. All of this should be reflected in the transfer pricing policy, so that transfer pricing outcomes demonstrate where value is created in the supply chain today. Transfer pricing policies could also uncover hidden opportunities. For example, how much risk can limited-risk entities take on? Can those entities share in pandemic-related losses? Is the company bound to a fixed rate of return? Where is the flexibility in your MNE group?

Are Advanced Pricing Agreements Still Advantageous?

Advanced pricing agreements (APAs) are contracts between tax authorities and taxpayers that stipulate in advance the transfer pricing criteria that a taxpayer should apply to avoid adjustments, penalties, and disputes with tax authorities. Taxpayers often rely on these agreements as a form of tax certainty. But in the year of Covid-19, there is no such thing. In fact, these contracts, intended to offer relief, are instead causing problems of their own. Given the pandemic, it's impossible for an advanced pricing agreement to both offer long-term protections and accommodate short-term economic disruptions. For example, these agreements are usually drawn up on the basis that a taxpayer's functions, assets, and risks will remain much as they were described in the contract. However, the pandemic has caused many taxpayers to shift these functions, assets, and risks, which could present a breach of a critical assumption. A taxpayer may consider reaching out to the IRS or foreign tax authorities to revise APAs, so they include a way to adjust static pricing and responsibilities to reflect the pandemic-induced realities of the business, but of course, the process could be arduous and painstakingly time consuming.

Financial Transactions

No doubt intragroup financing—loans, cost-sharing, treasury functions, guarantees—has proven a helpful tool during the pandemic, offering quick cash-flow relief. Unfortunately, it seems that liquidity alleviation comes with increased compliance burdens. Tax authorities are stepping up efforts to scrutinize financial transactions due to country-specific legislation, the OECD's new guidance, and the many questions that financial transactions, during Covid-19, raise. Strategies? To start, document financial transactions contemporaneously. As with any intercompany transaction—in good or bad times—documenting contemporaneously is helpful in keeping track of current market circumstances. In terms of Covid-19 transfer pricing, contemporaneous documentation will be instrumental in demonstrating a nexus between balance sheet items and the pandemic's impact on the company's financials and its overall tax position.

Usually, intercompany loans are a relatively straightforward analysis as arm's-length interest rates are stable and readily determined. Enter Covid-19, however, and fair-market interest rates are harder to ascertain. Businesses have been impacted in disproportionate ways—some even for the better—and so has perceived credit worthiness, as a result. Complicating the situation further is the fact that changes in the business environment may be fleeting should vaccines send the world back into "normalcy." Combine fluctuating credit risk with volatile interest rates and arm's-length interest rates are suddenly a very gray area. Is it an interest rate that goes to a risky borrower? Or an investment-grade rate based on the assumption that issues are temporary? And how reliable are third-party comparables in terms of strengthening an arm's-length position, given their own states of ambiguous solvency?

Robust documentation explaining the decisions forced by the Covid-19 pandemic will be imperative. The new OECD guidelines on financial transactions recommend an "accurate delineation analysis" to determine the amount of debt to be priced for tax purposes. Credit ratings, currencies, maturity, payment rank and terms must be considered to determine the transfer price. How is financing characterized—is there a risk that loans could be characterized as equity? Are arrangements logical from both the borrower's and the lender's point of view?

In economic downturns, companies may have trouble repaying intercompany loans, so it may be worth renegotiating the terms. Postponing debt repayment or interest payments could be the answer but be sure to find third-party comparables that demonstrate that the practice reflects the current market. Also, document changes in the terms of the loans and the options that were available.

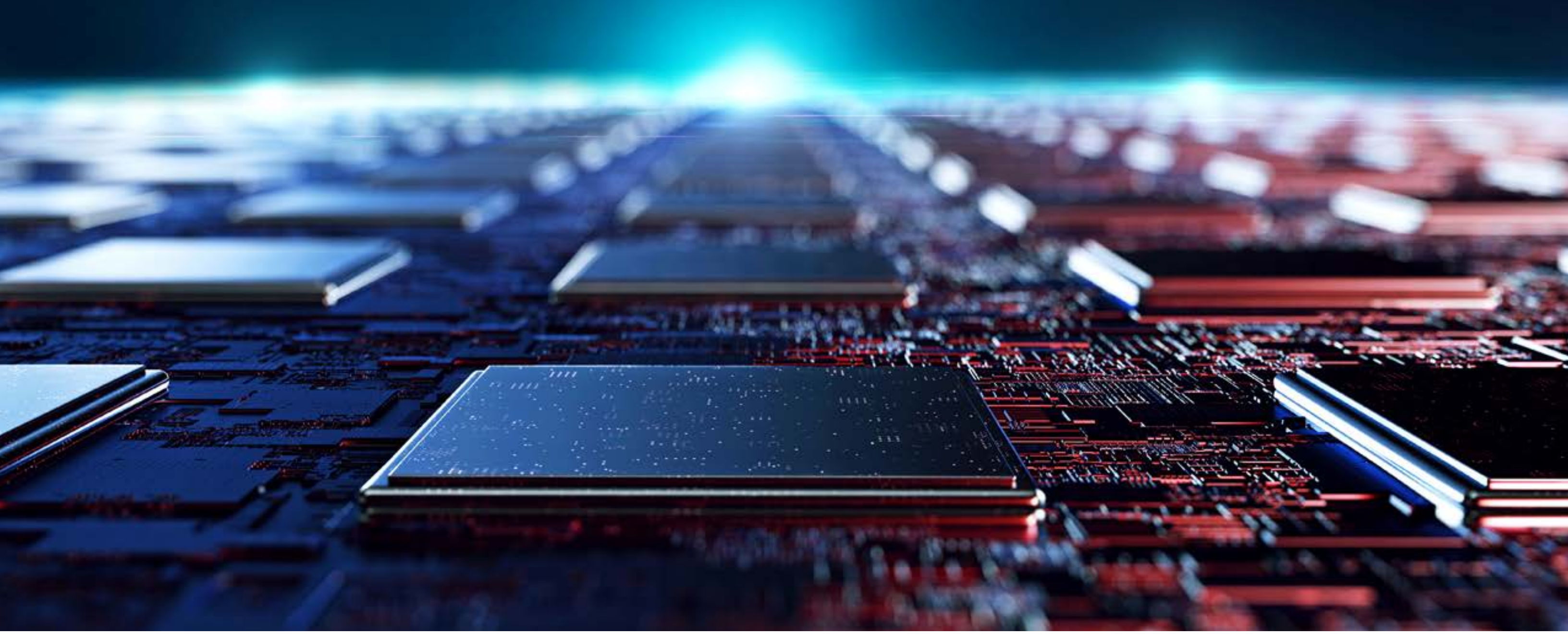
Contemporaneous Documentation

For many countries, contemporaneous documentation is not only recommended, but also required. Even in countries where it isn't part of the regulations, it's a worthwhile practice as tax authorities aren't exactly generous in terms of turnaround times once documentation is requested. Just having the documentation prepared by the time the corporate income tax is due may offer penalty avoidance and may count towards certain pandemic-relief measures from governments. But even without those rewards, contemporaneous documentation puts you in a better risk position as documenting the facts in real time adequately represents true market conditions.

Revisit Intercompany Agreements

Covid-19 has disrupted supply chains, displaced workers, and decreased economic demand. Any of those circumstances could be responsible for an entity underperforming, not performing, or being unable to pay for materials or services it's receiving—in other words, failing to fulfill its contractual obligations. Many businesses that can employ a *force majeure* clause—a legal exit strategy due to unforeseen circumstances—will. However, intercompany agreements don't always include them, the thinking being that related parties won't need the same protections as independent companies. So, renegotiating contracts may be the best option.

The trouble with renegotiating intercompany contracts is that the amendments often benefit one side of the relationship at the expense of the other. Still, related parties may be willing to negotiate to preserve the relationship or because the particular business needs could be difficult to fulfill elsewhere. In any case, an MNE will have to consider the transfer pricing implications. Tax authorities can challenge



intercompany amendments, but courts generally accept them as arm's-length based on the premise that third parties would have to renegotiate terms as well. Review contract revisions through a transfer pricing lens, based on the facts, circumstances, functional profiles, allocation of risk, and whether the current business practices and underlying economic substance are reflected in the terms of the intercompany agreements.

2021: Time to Embrace Technology

In the best of times, transfer pricing technology makes transfer pricing documentation more accurate, more efficient, and less subjective. But, for a year like 2020, it seems like technology is more of a necessity than a luxury, as companies are forced to control internal costs while continuously managing external risks. Pre-Covid, businesses were operating with lean tax departments, and now, even smaller, these departments are being tasked with the impossible.

The only way to do more with less is by enlisting technology. Transfer pricing-specific software can update professionals about international transfer pricing requirements, evaluate the impacts of tax policy and reform, calculate changes in the transfer pricing framework, and prepare accurate documentation—in other words, streamline the whole transfer pricing compliance process. Further, with the advent of machine learning and artificial intelligence, consumption and analysis of data is much quicker and more meaningful, resulting in real-time actionable steps that can help MNEs mitigate risk, optimize opportunity, and maximize control.

Transfer pricing-specific software can be especially useful in terms of benchmarking, as it can produce fresh benchmarking searches based on country-specific criteria instead of taking a generic one-size-fits-all approach. Given the pandemic's special circumstances, tax professionals will need fresh benchmarking searches reflecting current market conditions, or they may want to evaluate more historical periods that can provide better market insights. But with depressed budgets in MNEs' tax departments, outsourcing benchmark searches to high-priced consultants may be out of the question. When you consider that transfer pricing is a discipline focused on functions, a Google search for competitor information may not be the best source of benchmarking support. Transfer pricing-specific software that employs AI can make the benchmarking process as easy as a click of a button.

With so many transfer pricing red flags to choose from, tax authorities will have their pick of reasons for issuing information document requests (IDRS) to MNEs. Risking non-compliance just makes it easier for them. Covid-19 promises to heighten tax scrutiny—but that doesn't have to lead to audits and adjustments. With active and informed management of transfer pricing requirements and the help of technology, the savvy tax department will be able to navigate transfer pricing 2020 as smoothly as any other year.

Mimi Song is a chief economist at CrossBorder Solutions. She has more than 20 years of experience developing innovative and intelligent transfer pricing solutions for multinational corporations. As a practitioner with both consulting and industry know-how, she understands the administrative burdens imposed on taxpayers and the delicate balance between long-term sustainability and external risk management of international tax compliance. Her experience developing the end-to-end transfer pricing framework across people, processes, and technology uniquely positions her to understand how technology can be effectively applied to maximize budgets and minimize risk.

As CrossBorder Solutions, Song is responsible for managing client relationships and ensuring the successful completion of all work. At the original iteration, she served as Vice President of Professional Services. Following the sale to Thomson Reuters, Song was a Vice President at Duff & Phelps and served as the Head of Transfer Pricing at the Bank of Tokyo-Mitsubishi UFJ.

INSIGHT

Newly Remote Workers Will Bring New State and Local Tax Obligations

By Nicola M. White, Reporter

December 22, 2020

The Covid-19 pandemic has caused colossal changes to the U.S. economy, not the least of which has been the mass shutdown of traditional commuting patterns as tens of thousands of office workers have shifted to a virtual/telework/telecommute model. Corey L. Rosenthal and Lance E. Rothenberg of CohnReznick outline the helpful and not so helpful actions states are taking regarding the tax consequences of employees working in a state other than where they used to do their jobs pre-Covid.

Since March, thousands of employees have ceased working at their employer's traditional place of business and now telework from home, whether from a laptop at the kitchen table or at a new desk hastily situated in the basement (or another quiet space away from children, who are now themselves telecommuting to school). Moreover, perhaps thousands more of these workers have stopped living in their traditional residences, as they have temporarily relocated to a vacation house, a family member's house, or, for example, a rental home far away from their usual urban dwelling.

In a nation of 50 separate states, each with its own sovereign power of taxation, these shifts in workplace and other migrations across state lines can carry significant, complex, and perhaps surprising state and local tax consequences for both businesses and individuals alike. This article will briefly highlight several key pandemic-related issues that taxpayers should be cognizant of.

Taxation of Telework

Teleworking has always had the potential to create a host of tax compliance burdens for employers and employees. With advances in technology, telecommuting has slowly been creeping into the American workforce for the past two-plus decades. But with onset of the Covid-19 pandemic, a large segment of the U.S. workforce experienced a sudden and mass shift to telecommuting, and nearly 10 months into the pandemic, as businesses and workers have begun to adjust to the "new normal," the move to a remote workforce seems certain to become, at least to some degree, a permanent fixture of the workforce landscape.

For many employers, this likely means that their workforce may now be geographically dispersed across several, if not many, new jurisdictions beyond their original state footprint. While several state tax authorities have issued guidance addressing the implications of teleworkers crossing state lines due to Covid-19, more than half have remained silent. As such, businesses and their advisors need to take an inventory of their workforce and examine the laws of each state where they have employees performing services in order to evaluate the potential state and local tax implications.

The Business–Nexus and Related Considerations

It is generally accepted that telecommuting employees can create "nexus" on behalf of an out-of-state business, potentially leading to various tax obligations in a new state(s), including payroll taxes, income taxes, sales/use taxes, and various local taxes, among others. An employee's presence in a new state could mean that the out-of-state employer suddenly has nexus with the new state, necessitating registration, filing, and becoming familiar with the tax laws of jurisdictions that previously were never a concern.

From a payroll tax perspective, businesses need to ascertain whether employee relocations may create new withholding requirements. Generally, employers are charged with withholding income taxes based upon the location where an employee performs services. With a virtual workforce, employees may now be working from anywhere. Some states, such as New Jersey, have granted temporary relief by relaxing payroll nexus standards for Covid-19 teleworkers. Others, like Massachusetts and New York, have issued guidance attempting to continue to tax nonresidents as if they were still working at the employer's place of business. Each of these situations can create a complex set of new issues that employers need to consider and address.

From an income tax perspective, businesses need to evaluate whether any new nexus or employee presence impacts their formulas for multistate apportionment of business income. While nexus determines whether a state can impose tax, apportionment determines how much income is subject to tax. The presence of employees or company property in a new jurisdiction may impact apportionment formulas based on payroll and property factors; newly establishing nexus in a state in which the company happens to have high in-state sales volume may create a significant new tax liability if that state utilizes a single-sales factor apportionment formula. Further, establishing nexus in a new state through employee relocations could potentially impact other items such as Public Law 86-272 protections, as well as alter pre-pandemic cost of performance sourcing methodologies.

From a sales and use tax perspective, businesses may find themselves with registration, collection, and remittance obligations in states reflecting their altered workforce footprint. In 2018, the U.S. Supreme Court's *Wayfair* ruling abrogated the physical presence requirement and ushered in economic nexus for sales tax purposes. Consequently, many remote sellers of taxable goods and services are now subject to each state's recently enacted *Wayfair* provisions. These do include small-seller threshold exceptions; in many states, a remote seller does not have economic nexus with a market state unless it exceeds greater than $100,000 or 200 transactions in that state. However, with a virtual workforce, the presence of a telecommuting employee in a new state could trigger the physical presence standard, and thus the business would no longer qualify as a remote seller, losing the small-seller threshold protections.

At present, only a handful of states have issued any guidance addressing Covid-19 teleworker nexus considerations. Several states (*e.g.*, New Jersey) have granted nexus relief,

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but only for a temporary period. Other states (*e.g.*, New York and Massachusetts) have sought to clarify that they, indeed, expect to collect personal income taxes arising from these new arrangements, notwithstanding the pandemic. In summary, businesses need to begin to plan now to avoid future nexus compliance pitfalls and to be in a position to assess state and local tax risk arising from employees working remotely from states where the employer previously had no state or local tax filing obligations.

The Worker—Residency & Related Considerations

In a multistate environment, individuals should also consider the potential impact of residency rules. From a personal income tax perspective, there are essentially three ways a state, which administers a personal income tax, can impose its tax. Two apply to residents, who owe tax on their worldwide income. There are two ways to qualify as a resident. The first is domicile, which reflects an individual's true home. The second is statutory residency. Under New York's and New Jersey's rules, for example, if a taxpayer maintains a permanent place of abode and spends greater than 183 days in that jurisdiction, then that individual is treated as a resident (*i.e.*, a "statutory" resident) regardless of whether they are a domiciliary of their home state. The third way states can impose tax is to impose tax on nonresidents upon any income sourced to the taxing state. For example, a New Jersey resident who traditionally works in New York for a New York business would owe tax to New York on their income earned from that business and sourced to New York.

Tax migration can raise both residency and nonresident allocation issues. Is a New Jersey resident who used to work in Manhattan but now teleworks from home, in fact, subject to tax by New York? Is a New York City resident who has relocated to her Florida beach home able to stop her New York payroll withholdings? If a Brooklyn-based business allows its workforce to go virtual, and an employee terminates his New York lease, and then moves to his parents' in Illinois for three months, and then with laptop in hand moves with some friends to a rented house in Hawaii for six months, is he able to claim he changed his tax residence away from New York?

These are complex questions that require a rigorous facts and circumstances analysis. There are multiple permutations reflecting the reality that Covid-19 has dispersed a large swath of the U.S. workforce across the country. Some relocations will be permanent, others will be only temporary, but all of them require a careful tax analysis.

Tax Planning—The Time is Now

These are complex issues in large part because there is a patchwork of different rules on a state-by-state basis. Employers and employees should monitor their relevant states for guidance addressing these types of issues. Further, these complexities are aggravated by conflicting state rules. For example, New Hampshire has sued Massachusetts over Massachusetts' efforts to continue to impose income tax on New Hampshire residents who used to work in Massachusetts but are now working from home in New Hampshire. Similarly, New York has stated its intention to continue to impose income tax on New Jersey and Connecticut residents who used to work in New York but are now working from home in New Jersey and Connecticut. In response, the New Jersey legislature has considered legislation requiring the state Treasurer to examine New York's efforts to tax New Jersey residents and to consider whether New Jersey should join in New Hampshire's litigation. Employers and employees need to understand the current landscape of the varying state rules and consider undertaking a nexus diagnostic/review so that they can minimize their state and local tax risks.

All of these issues are only intensified by the budgetary crunch that many states and localities are facing due to the pandemic-induced recession. The border disputes between New Hampshire and Massachusetts and perhaps between New York and New Jersey have the potential to lead to either significant opportunities for interstate cooperation or interstate skirmishes where taxpayers may suffer the brunt.

At this point, there are more questions than answers. Businesses, employees, tax advisors, and state policymakers should continue to examine these issues. Companies must evaluate their telework footprint and track the locations of their workforce. Individuals need to understand the complex residency rules affecting their state tax compliance burdens. Needless to say, all taxpayers should be vigilant and monitor their states for additional guidance.

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INSIGHT

Massachusetts 2020 Tax Litigation Summary

By Nicola M. White, Reporter

December 22, 2020

Philip Olsen of Davis Malm looks at some of the significant Massachusetts tax cases of 2020 and the effect Covid-19 has had on tax controversy in the state, noting that property tax assessments make up the majority of Massachusetts tax cases.

Philip Olsen of Davis Malm looks at some of the significant Massachusetts tax cases of 2020 and the effect Covid-19 has had on tax controversy in the state, noting that property tax assessments make up the majority of Massachusetts tax cases.

Despite the Covid-19 pandemic, the Massachusetts Appellate Tax Board and the state's appellate courts managed to carry on in 2020, albeit remotely. The Appellate Tax Board suspended all in-person proceedings but conducted a few evidentiary hearings by videoconference. The Supreme Judicial Court and Appeals Court also used video conference technology for tax appeal oral arguments. The Appellate Tax Board issued 36 formal decisions in 2020, while the Supreme Judicial Court and the Appeals Court issued two and three tax opinions, respectively.

It is beyond the scope of this article to address all reported decisions, but several opinions released during the year are worth noting, one of which was the corporate excise appeal of *VAS Holdings*. Here, the taxpayer argued that a gain on the sale of a 50% interest in a limited liability company operating in Massachusetts was not taxable in Massachusetts. The parties had agreed that the relationship between the taxpayer and the LLC was not unitary, and the LLC did not serve an operational function. In ruling for the Massachusetts Department of Revenue, the Appellate Tax Board distinguished "investee apportionment" from "investor apportionment."

While investor apportionment is based on the in-state activities of the taxpayer/investor, the investee apportionment methodology focuses on the activities of the second entity (in this case, the LLC). The board held that the increase in value of the LLC and the gain from the sale were inextricably connected to and largely derived from property and business activities of the LLC in Massachusetts. Accordingly, the board concluded that there was no constitutionally impermissible taxation of extraterritorial values. *VAS Holdings & Investments LLC v. Commissioner of Revenue*.

The Massachusetts Appeals Court in *Bay State Gas Co.* ruled that the taxpayer was entitled to a deduction for amounts remitted to Indiana as payment of the Indiana Utility Receipts Tax (URT). Under Massachusetts law, corporate taxpayers must add back taxes "measured on or by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business, and capital stock taxes imposed by any state." The court determined that the URT was deductible because it was more like a transaction tax, imposed on the receipts of the retail sales of gas and electricity in Indiana, than a franchise tax for the privilege of doing business in the state. *Bay State Gas Co. v. Commissioner of Revenue*.

Citrix Systems addressed the application of sales tax to online software offerings. In Massachusetts, custom software is generally exempt from sales tax, while standardized software is generally taxable. The Supreme Judicial Court held that Citrix's sales of online software offerings represented the taxable sales of prewritten computer software pursuant to Massachusetts General Laws Chapter 64H Section 1. The Court rejected Citrix's argument that its subscription fees were not taxable transfers of property because customer transactions did not involve the transfer of software title or possession. *Citrix Systems, Inc. v. Commissioner of Revenue, Mass.*

The case of *New Cingular Wireless* was one of several actions filed in various states, following a class action settlement, seeking refunds of sales tax wrongfully collected on data charges in violation of state tax laws and the Internet Tax Freedom Act (ITFA). The Appellate Tax Board ruled that data charges were charges for internet access and protected from taxation by the ITFA. The Commissioner of Revenue appealed the decision claiming that New Cingular failed to comply with the screening software provision of the ITFA. Internet access providers are required "at the time of entering into an agreement with a customer" to "offer … screening software that is designed to permit the customer to limit access to material on the Internet that is harmful to minors." Internet access providers who fail to meet this requirement are ineligible to claim the protection of ITFA, subjecting data charges to be taxed. The Appeals Court concluded that the availability and advertising of screening software by New Cingular complied with the screening software requirement of the ITFA despite the fact that New Cingular's screening software features were not compatible with some devices sold by the appellant. *New Cingular Wireless PCS LLC v. Commissioner of Revenue*.

In the personal income tax case of *David Pogorelc,* the Massachusetts Appeals Court held that the taxpayer was estopped from retroactively challenging a previous tax position because of a principle referred to as the "duty of consistency." On his 2007 Massachusetts personal income tax return, Pogorelc deducted losses realized upon the disposition of a partial interest in an LLC. In 2011 he reported gain realized upon the sale of the principal asset held by that LLC. The taxpayer argued that he should not have realized a loss in 2007 because the transaction was a merely "fictional" sale under Revenue Ruling 99-5. Although not previously applied in Massachusetts law, the duty of consistency is well established in federal tax law. It prevents a taxpayer who has already benefited from taking a certain position on a tax issue from later taking an inconsistent position on the same issue in order to further his benefit. *Pogorelc v. Commissioner of Revenue*.

Covid-19 has had a devastating impact on the commercial real estate market. The natural consequence of this will be a dramatic increase in challenges to property tax assessments. Recent studies indicate that local property taxes comprise nearly 40% of state and local taxes paid by businesses. In fact, most tax litigation in Massachusetts involves appeals of property tax assessments, typically addressing overvaluation or exemption issues.

There are many statutory exemptions from local property tax in Massachusetts. Some are based on the taxpayer's identity or status, while others look to the property's character or use. Exemption cases decided in 2020 include *United Salvage Corp. of America v. Framingham* (solar photovoltaic system), *Trimont Foundation v. Newton* and *Roman Catholic Bishop of Springfield v. Easthampton* (charitable exemption), and *Veolia Energy Boston v. Boston* (manufacturing corporation exemption).

While property tax exemption appeals present interesting factual and legal questions, cases alleging overvaluation are far more common. The cases of *Western Massachusetts Electric Co. v. Springfield* (utility company), *Digital 55 Middlesex LLC v. Billerica* (data center), *Patrick Motor Mart v. Auburn* (auto dealership), and *HCRI Massachusetts Properties Trust v. Worcester* (senior living facility) were decided in 2020 and illustrate the Appellate Tax Board's analysis of various valuation issues.

It is difficult to predict what impact the Covid-19 pandemic will have on the litigation of state and local tax controversies in 2021. State tax revenue shortfalls may very well result in increased audit activity—and the tax disputes that often follow. New cases and those currently in the pipeline will need to be addressed. In the meantime, we expect that the Massachusetts Appellate Tax Board will keep issuing decisions and rely on remote hearings until the state is back to some level of normalcy.

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INSIGHT

Busy New Year: Predicted IRS Enforcement Trends in 2021

By Kat Gregor, Tax Controversy Practice, Elizabeth Smith, Counsel, and Isabelle Farrar, Ropes & Gray LLP

December 31, 2020

Next year promises to be a busy one for IRS enforcement. Kat Gregor, Elizabeth Smith, and Isabelle Farrar of Ropes & Gray examine seven potential areas of focus, including TCJA-related audits and increased partnership tax compliance.

This week we close the books on a long, challenging year and welcome all that 2021 has to offer! While we look forward to many aspects of the New Year, we predict increased enforcement activity by the Internal Revenue Service. The agency's response to the Covid-19 pandemic, the People First Initiative, put most new enforcement on pause for several months in mid-2020, but new audits steadily ramped back up in the fall. This trend is likely to intensify with the incoming Biden administration, which is expected to increase both civil tax enforcement and criminal tax prosecutions.

In recent months, the IRS has provided some insight into its enforcement strategies and priorities for the future. Leveraging that information—along with our own experience and what we hear from fellow practitioners—we predict what we expect to be the IRS's top enforcement priorities in the New Year.

TCJA-Related Audits

The IRS has begun to examine taxpayers' compliance with provisions of the Tax Cuts and Jobs Act ("TCJA"), and we expect it to begin more tax reform-related audits in 2021. The IRS first signaled its attention on TCJA compliance in late 2019, when its Large Business & International division launched a campaign to examine U.S.-based multinationals' 2017 and 2018 returns for compliance with the repatriation tax under Section 965of the Internal Revenue Code of 1986.

LB&I next rolled out a broader TCJA-focused compliance campaign in May 2020. This campaign allows the IRS to better understand taxpayers' behavior under the TCJA and to consider compliance with its provisions on a holistic basis. Expected treatment streams include examinations, soft letter, outreach, new practice units, and the launch of future campaigns. In August 2020, LB&I launched a compliance campaign that targeted individual compliance with Section 965 through examinations and soft letters. Later that month, the IRS announced it would begin enforcing Section 965's repatriation tax in October 2020 through two methods: letters to taxpayers who it believed needed to comply more fully with Section 965, and audits of taxpayers it believed failed to comply with their transition tax obligations.

Then, in October 2020, the agency revised the Section 965 compliance campaign that it first launched in late 2019 to refocus on identifying and addressing taxpayers with potential material compliance risk. Taxpayers selected for Section 965 examination will also be examined for other material issues, especially those related to TCJA planning.

Examinations of TCJA items are new territory for the IRS. Early experience with Section 965 audits shows that examiners are focusing on earnings and profits (E&P) calculations, foreign tax credits, foreign tax pools, and transactions occurring in 2017–2018, including those that reduced cash and E&P. Indeed, an IRS representative confirmed in a December 2020 webinar sponsored by the District of Columbia Bar Taxation Community that exam teams are using a relatively standardized information document request (IDR). Audits of TCJA-related areas will also include compliance with the base erosion anti-abuse tax (BEAT), global intangible low-tax income (GILTI), and foreign-derived intangible income (FDII) provisions, as well as Code Section 163(j)'s interest deduction limitation.

Against this backdrop of increased enforcement, some taxpayers have already challenged certain TCJA regulations in court. In *FedEx Corp. v. United States*, the taxpayer has brought a refund claim challenging the foreign tax credit portion of the Section 965 regulation as invalid, in part due to a conflict with the statute. The case is pending in the Western District of Tennessee. Likewise, in *Liberty Global, Inc v. United States*, the taxpayer has filed a refund claim in the District of Colorado that challenges the regulations promulgated under Code Section 245A. It argues that the rules contradict the statute, suffer from procedural defects, and apply retroactively in an impermissible manner. Taxpayers under audit and the IRS will surely watch these cases closely.

Partnerships' Tax Compliance

The New Year promises increased partnership audits under the Bipartisan Budget Act's partnership audit regime that became effective on Jan. 1, 2018. While the number of partnership audits has grown over the past two years, LB&I has signaled in its 2021 Focus Guide that the trend will intensify in 2021. LB&I is also developing a program for partnerships that is similar to its Large Corporate Compliance (LCC) program, which uses data analytics to automatically target large and complex corporate taxpayers having compliance risk for examination. Indeed, the Focus Guide prioritizes expanding the LCC program to partnerships.

Forthcoming partnership audits will focus on a variety of areas. The IRS is not limiting TCJA compliance audits to corporations, and many aspects of tax reform impact partnerships. LB&I has signaled areas of partnership-related scrutiny in certain compliance campaigns. One campaign focuses on whether distributions to partners are subject to employment tax under the Self-Employment Contributions Act (SECA) tax. Further, the IRS has long shown interest in items impacting private investment funds that typically structure using partnerships, including with respect to carried interest, management fee offsets and waivers, and the treatment of monitoring fees that investment fund affiliates receive from portfolio companies.

The IRS's focus on partnerships' compliance extends to their current reporting obligations. The Service has recently required partnerships to report information regarding partners' capital accounts on Schedule K-1 of Form 1065 ("U.S. Return of Partnership Income"). It is also scrutinizing international aspects of partnership reporting. We anticipate that these areas will become the topics of future audit and enforcement activity.

Stock-Based Compensation Cost-Sharing Arrangements

We expect 2021 will bring continued audits of taxpayers' stock-based compensation cost-sharing arrangements. The IRS has already started examining taxpayers that didn't include stock-based compensation costs as intangible development costs under Treasury Regulations §§ 1.482-7A(d)(2) and 1.482-7(d)(3). These examinations are taking place in the wake of the Supreme Court declining to review the Ninth Circuit's decision in *Altera v. Commissioner*. In *Altera*, the Ninth Circuit reversed the Tax Court's 2015

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decision that invalidated the regulations. The audits come as no surprise: The IRS announced in a [July 31, 2019 LB&I memorandum] that it was lifting its administrative moratorium on examining such cost-sharing arrangements in the wake of the Ninth Circuit's decision, and encouraged the opening of new examinations of cost-sharing arrangements. Even though *Altera* only controls in the Ninth Circuit, the IRS indicated that the decision will help its position in all matters before its Independent Office of Appeals and in any future litigation.

Companies that took positions excluding stock-based compensation from cost-sharing arrangements could come under audit given the IRS's focus. Likewise, any company that filed refund claims in response to the 2015 Tax Court decision invalidating the regulations should expect to see its refund claim denied.

High Net Worth Individuals

It is no secret that the IRS has increased scrutiny of high net worth individuals in recent years, and LB&I's 2021 Focus Guide suggests the trend will continue in the New Year. LB&I has employed a global high-wealth program, also known as the IRS's "wealth squad," for several years. The wealth squad focuses its examinations on obtaining complete financial pictures of high net worth individuals and the entities they control. In July 2019, it announced a high-income non-filer compliance campaign that would target taxpayers who have not filed required tax returns.

The IRS said in February 2020 that it would increase face-to-face visits with high-income individuals who had failed to file returns. While the People First Initiative mostly paused those efforts, when the moratorium on new examinations expired in July 2020, LB&I announced that it would begin a wave of audits of high-income non-filers having interests in partnerships. This increased focus came on the heels of a May 2020 report, "High-Income Non-Filers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service," by the Treasury Inspector General for Tax Administration (TIGTA).

IRS enforcement efforts aimed at high net worth individuals are not limited to non-filers. LB&I also has a compliance campaign focused on individuals who have expatriated and have not met their payment or filing obligations. As previously mentioned, LB&I initiated a campaign focusing on individuals' compliance with Section 965 in August 2020. And, as we discuss below, the IRS is targeting holders of virtual currency and compliance with FBAR and FATCA filing obligations.

In targeting high wealth individuals for audit, the IRS is likely to use one of the key weapons in its arsenal: data. The data isn't limited to the mass of information it can glean from filed returns. The agency has vastly enhanced its data analytics capabilities in recent years, and is now able to pool and leverage data from many different sources, including publicly available information from social media, as well as from publicly published leaked data. Other sources include information that it has received through formal discovery (such as the Coinbase summons response), from other U.S. government agencies, and from other countries. The IRS is using newly developed computer tools—including artificial intelligence—to quickly identify interrelationships among taxpayers, third parties, and assets, including virtual assets. We expect it will leverage these tools to identify and work high-net worth individual audits.

Virtual Currency

In 2021, the IRS will continue its long effort to bring virtual currency holders into compliance, leveraging recent filings, international cooperation, and robust data analytics. The agency has explicitly prioritized enforcement of virtual holdings since July 2018 when LB&I launched a campaign targeting cryptocurrency. Since then, it has increasingly ramped up its activities.

The New Year will allow the IRS to leverage recent virtual currency filings-both responses to targeted letters and routine filings-in its enforcement efforts. In July 2019, the IRS sent three types of letters to taxpayers regarding potential non-reporting of virtual currency transactions (Letters 6173, 6174, and 6174A). It reported that these letters resulted in the filing of certain amended returns. Routine tax forms that all individual taxpayers are required to file now include questions related to virtual currency. For filings made in 2020 related to the 2019 tax year, these questions were located on the 2019 Form 1040's Schedule 1 that many filers don't use. There, filers were forced to answer whether, "[a]t any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" Going forward, *all* filers will be forced to answer that question, because for filings made in 2021 related to the 2020 tax year, the question is now located on the 2020 Form 1040, *not* only on the Schedule 1. These routine filings will mean the IRS has multiple years of information regarding virtual currency to leverage, making it easier to establish the intent necessary for elevated penalties and for criminal prosecution.

Virtual currency enforcement in 2021 will likewise leverage expertise developed in the recent past. A global effort to target virtual currency holders was publicized in the November 2019 Crypto Challenge of the Joint Chiefs of Global Tax Enforcement, or J5, which groups the revenue authorities of Australia, Canada, the Netherlands, U.K., and U.S. The Crypto Challenge provided a publicly visible example of collaboration between these tax authorities and data scientists to identify non-compliance.

There are many processes in place for such information-sharing between countries, including through the U.S.'s Foreign Account Tax Compliance Act (FATCA) reporting, as well as international processes such as Automatic Exchange of Information (AEOI), Exchange of Information on Request (EOIR), common reporting standards (CRS), and country-by-country (CBC) reporting.

Indeed, the Crypto Challenge was quickly followed by the J5's Day of Action in January 2020, with coordinated international enforcement actions against tax evaders. In a November 2020 message, James Lee, the new head of IRS Criminal Investigations, publicly reiterated his support for the J5 collaboration, and noted that the agency's "investment in cybercrimes and data analytics has positioned [the IRS] to be at the forefront of cases involving cryptocurrency."

More recently, a high-profile arrest and indictment by the U.S. Department of Justice and the IRS shows that the IRS is making good on its promises to make virtual currency holders pay their fair share to the federal government. In that case, the DOJ and IRS announced on Dec. 9, 2020 the arrest and indictment of Amir Bruno Elmaani, better known as "Bruno Block," for tax evasion. Block is the founder of the virtual currency Oyster Pearl and was indicted for failing to report income to the IRS. The U.S. Securities and Exchange Commission simultaneously charged him with conducting an illegal securities offering.

FATCA and FBAR Compliance

The IRS has focused on international compliance with respect to foreign financial accounts in recent years, and we expect the trend to continue in the New Year. Foreign Bank Account Reports (FBARs) and FATCA impose overlapping disclosure requirement for holders of foreign bank accounts, and the banks themselves. FBARs are required filings for holders of foreign bank accounts. FATCA requires international financial institutions to report data to IRS. LB&I announced in October 2018 a campaign targeting FATCA filing accuracy. IRS announced in a July 2020 memorandum the resumption of FBAR examinations, and announced in a November 2020 memorandum that FBAR enforcement activity would be continuing. The IRS also continued to initiate new FATCA exams, even during the COVID-19 crisis. It has seen increased cooperation from some foreign governments, with Canada and Switzerland announcing that their financial institutions would cooperate with FATCA requirements.

Two court decisions released in late 2020 have made it even easier for the IRS to prosecute FBAR-related violations: the Fourth Circuit's October 2020 decision in *Horowitz v. United States*, and the Eastern District of Pennsylvania's December 2020 decision in *Bedrosian v. United States*. In both cases, the taxpayers—holders of Swiss bank accounts—were challenging penalties asserted by the IRS. In *Horowitz*, the Fourth Circuit held that the taxpayers had recklessly disregarded FBAR filing requirements and could therefore be assessed a penalty for a willful violation.

In *Bedrosian*, the district court—on remand from the Third Circuit—similarly supported the imposition of a penalty for a willful violation. Importantly, the *Bedrosian* court expanded the concept of willfulness by assessing the taxpayer's intent *objectively*, not subjectively: "This court's prior analysis was focused almost entirely on Bedrosian's subjective intent and did not adequately consider whether the evidence warranted a conclusion, from an objective point of view, whether Bedrosian acted either 'knowingly or recklessly.' " These two decisions will likely clear the way for the IRS to assert elevated penalties against taxpayers. This may prove to be a significant source of income for the IRS, as willful penalties for FBAR violations can be up the greater of $100,000 or 50% of the amount in the account.

CARES Act and Other Pandemic-Related Matters

The IRS has already begun to examine compliance with requirements related to the various COVID-related assistance measures provided to taxpayers by the federal government, including through provisions of the Coronavirus Aid, Relief, and Economic Security, or CARES, Act. Related IRS enforcement activities in 2020 have initially focused on possible criminal activity: for example, charging individuals for fraudulently obtaining Paycheck Protection Program ("PPP") loans, economic impact payments ("EIPs"), and unemployment assistance. We expect this trend to continue into 2021.

The CARES Act also created opportunities for taxpayers to receive refunds arising from net operating losses (NOL). Agency statements in 2020 show that officials are expecting a wave of CARES Act-related refund requests, and are preparing their staff to audit the claims. The IRS is also working closely with the Joint Committee on Taxation (JCT), which will have to approve many of the requests. The JCT must approve tax refunds in excess of $2 million, or $5 million for C Corporations. We expect that large CARES Act-related refunds will receive close scrutiny, especially in light of legislators' (rejected) proposals to reverse the CARES Act NOL carrybacks. We also anticipate that a material portion of refund claims will be disputed by the IRS, particularly in light of these comments.

Requests for refunds based on NOL carrybacks can affect existing audits—and also trigger new audits. If the taxpayer is already under examination, the exam team will often review the carryback, even if it is outside of the years under review. This often adds time and complexity to an audit. Taxpayers not under audit who file refund claims attributable to NOLs often come under exam for the year (or years) giving rise to the NOL, as well as the years to which the NOL is carried back, even if the statute of limitations has expired. When examining closed years, inspectors can look for unrelated issues to reduce any tentative refund that was already paid, and they may also adjust closed-year items to reduce the amount of the carryback available for other years. Audits of large losses are common and often fast-paced, as the IRS anticipates that taxpayers claiming substantial losses may pose collection risks.

The New Year promises to be a busy one for IRS enforcement. In addition to the areas of focus detailed in this article, we expect the IRS to continue scrutinizing syndicated conservation easements and microcaptive insurance arrangements to identify potential taxpayer abuse. The Service has likewise devoted significant resources to stepping up its fight against civil and criminal fraud, including by creating and staffing a new Fraud Enforcement Office housed in its Small Business/Self Employed Division in 2020. A key part of its mission is to coordinate fraud investigations between the IRS's civil divisions and its Criminal Investigative division. We anticipate that the Fraud Enforcement Office will be very active in 2021, both in connection with initiatives detailed in this article and beyond.

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INSIGHT

Key Legal, Tax Considerations for Relocated Long-Term Remote Workers

By Kat Gregor, Tax Controversy Practice, Elizabeth Smith, Counsel, and Isabelle Farrar, Ropes & Gray LLP

December 31, 2020

Employees who are working remotely from other states and jurisdictions to which they relocated for the long term because of Covid-19 raise some important legal issues for employers. Morgan Lewis & Bockius attorneys examine these issues.

As the number of Covid-19 cases continues rising throughout the country, many employers and employees are exploring not only how to work remotely, but how to handle new long-term remote working arrangements in new locations while mitigating unintended consequences and liability.

Following are some legal issues to consider in these situations involving ongoing remote work arrangements.

Tax Payments

Businesses should be aware that remote working arrangements where the employee works in a different state (or locality) than they worked prior to the pandemic, particularly if it is a location where the employer is otherwise not operating, may inadvertently trigger state payroll tax registration and filing requirements. These requirements can include having to adjust tax payments for an individual employee and potentially may subject an employer to another state's payroll tax regime.

Generally, in jurisdictions that have a personal income tax, businesses are required to register and withhold taxes on wages of employees in that location if they meet the applicable threshold to register and if an employee performs services in these states. However, there are exceptions that apply in certain states, including reciprocity agreements, convenience of employer rules, and Covid-19 payroll-tax relief laws.

Remote working arrangements where employees are working in locations where an employer was not otherwise operating may also provide the jurisdiction with enough nexus to impose corporate income/franchise tax filing obligations and a potential corporate income/franchise tax liability.

Businesses should also be aware that arrangements where employees are working remotely in countries where an employer was not otherwise operating may trigger a permanent establishment or "taxable presence" in that country and give rise to corporate income tax or other taxes on business activity in that country or tax jurisdiction.

Leave and Wage Replacement Entitlements

Many jurisdictions have general use paid sick leave laws or Covid-19 leave laws that apply based on the employee's work location, some of which require companies to provide employees with notice of their sick leave balances on pay stubs.

Similarly, some states have extensive time off provisions mandating leave for a variety of reasons, including pregnancy, disability, bereavement, or to do school visits, among others, that must be considered.

Wage-and-Hour Issues

Off the Clock/Timekeeping/Breaks. There can be significant liability if an employee is working "off-the-clock," particularly as managers may be less able to control and closely monitor remote worker hours. Additionally, some jurisdictions have strict rules on when employers must provide meal and rest breaks to employees, including remote workers.

Minimum Wage and Overtime. Certain states and cities have specific wage-and-hour laws that apply to remote workers in that jurisdiction, including higher minimum wage rates, daily overtime/split-shift pay laws, laws that prohibit last-minute schedule changes, or that require mandatory rest days.

Expense Reimbursement. Certain jurisdictions have statutes that require employers to reimburse employees for workplace expenses, potentially including phone and internet for remote workers.

Exempt Employee Issues. For exempt employees, some states require that employees primarily perform exempt duties and earn a certain fixed salary to maintain their exempt classification.

Wage Statement Requirements. Many jurisdictions have specific requirements for information that needs to be included in employee wage statements or pay stubs as well as substantial penalties for non-compliance.

Training Requirements

Certain jurisdictions require that employees and/or managers working in that location receive mandatory training, including on safety considerations or sexual harassment prevention. These laws can be triggered when an employee is working remotely from a new location.

Immigration Compliance

Workers on certain immigration visas may have an assigned work location. If the individual is working from a different location, potentially even including working from home, it could impact their work visa.

Work-from-home arrangements and relocation for employees working under visa status should be carefully reviewed in advance.

Business Certification and Licensing

Employers in industries that require either business certifications or have employee registration and licensing requirements should confirm that all appropriate certifications and registrations are in place before approving long-term remote work for an employee in a new jurisdiction.

Confidentiality

In addition to being a best practice, maintaining confidentiality is often required by statute, such as under HIPAA, state law, or under various fiduciary and financial obligations. Failure by an employee working remotely to keep covered information confidential could potentially create liability for a business.

Performance Management Concerns

In addition to the legal concerns, many employers struggle to effectively manage the performance of employees who are working remotely full-time.

Employers should consider taking proactive steps to foster the productivity of teleworking employees. These steps could include sending communications (or entering a formal agreement) to clarify remote working expectations and parameters including specific guidelines on the duration of the arrangement; productivity metrics; work-hour expectations; rest and meal break requirements; record keeping requirements; workers' compensation/OSHA issues; confidentiality requirements, benefits available to employees; and expense reimbursement obligations.

Employers also should consider training managers on how to effectively manage and review the performance and timekeeping of employees working remotely.

In conclusion, though there is research showing remote work (or partial remote work schedules) can increase worker productivity and well-being, employers who have implemented or expanded long-term remote work programs during the Covid-19 pandemic should be proactive in addressing the ways that remote work can create workplace complications and litigation risk.

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Public companies anticipated and planned for the challenges in applying CECL. However, those efforts were complicated by the pandemic. Above, pedestrians cross a street near the New York Stock Exchange on Dec. 17.

Photographer: Angus Mordant/Bloomberg

INSIGHT

The Wild Ride of 2020 for CECL—Investors and Preparers Hope for a Typical 2021

By Kat Gregor, Tax Controversy Practice, Elizabeth Smith, Counsel, and Isabelle Farrar, Ropes & Gray LLP

December 31, 2020

The challenges involved in implementing the current expected credit losses (CECL) accounting standard were anticipated. The Covid-19 pandemic was not. Thomas Barbieri of PwC looks at how companies handled it and what to expect in 2021.

As 2020 comes to a close, so does the first year of application of the current expected credit losses (CECL) impairment model for most public companies. As with the implementation of most major accounting standards, companies anticipated and planned for the challenges in applying CECL. However, these best laid plans were complicated by the uncertainty caused by the Covid-19 pandemic, which upended much of the world in the first quarter of CECL's application.

Since its issuance in 2016, companies most impacted by the credit losses standard spent significant time and resources developing controls and processes to capture and utilize historical data and analyze current and forecast future economic conditions in order to estimate future lifetime credit losses. Financial models were built to forecast credit losses and were calibrated based, in part, on observed relationships between loan data, macroeconomic variables (such as the U.S. unemployment rate or gross domestic product) and historical credit loss experience.

Controls and processes were put in place to establish a level of corporate governance expected and required from public companies and regulated entities. Many preparers established implementation work plans that started early so that models, controls, and processes would be in a position to operate under a "business as usual" environment beginning in Q1 2020. Unfortunately, like almost every aspect of our lives, the Covid-19 pandemic and its economic impact had a dramatic effect on preparers plans. While companies had already determined the impact of adoption and recorded their transition adjustments, they weren't able to complete one full quarter using the CECL model before the pandemic would test whether management's judgments and processes were reasonable.

2020 has been anything other than "business as usual" and everyone's daily routine is nothing like it was when this year began. Employees had to pivot and adapt to a remote working environment, resulting in a need to ensure controls and processes could still work effectively. The data points and macroeconomic forecasts fed into the credit loss estimation models were stressed beyond the levels to which models were calibrated and forecasts were changed dramatically and frequently given the uncertainty and evolving views of the future. Governments around the world reacted by providing an unprecedented amount of economic stimulus, such as direct payments to individuals and/or enhanced unemployment benefits and programs to support businesses, which resulted in a disconnect between the models correlation of expected credit losses and macroeconomic data (e.g., U.S. unemployment rate). Companies had to react quickly and decisively in all aspects of their business, including when it came to estimating future credit losses. For a number of financial assets, expected future credit losses is a complex highly judgmental management estimate even in stable economic times.

While all companies need to estimate credit losses under the CECL model, similar to other accounting and reporting matters, they have different portfolios of assets, so may use different policies, process, controls, and quantitative models to generate the estimate. As a result, there is not a "one size fits all" solution in adapting estimates to the economic environment. Some preparers adjusted quantitative inputs into (or correlations within) their financial models. Many companies utilized qualitative overlays to adjust the output from credit loss models to address current conditions and economic forecasts not considered in the models. Regardless of the methods used to adjust their estimates, the shared goal remained: developing a reasonable estimate of expected credit losses.

With the benefit of hindsight, the allowance for credit losses estimated under the CECL model generally increased over the first six months of 2020, but at many institutions the allowance remained relatively "flat" in the calendar year third quarter. In certain asset classes, credit losses estimated by companies have not yet been "realized," in part due to loan modification and deferral programs, government stimulus, and other factors. What has been reinforced over the first half of the year is the need to have appropriate documentation on how the allowance for credit losses is determined. Not only from a quantitative perspective, but equally as important, from a qualitative perspective.

As previously mentioned, significant adjustments, whether at the front end or back end of the models, took place over the reporting cycles, meaning that the delineations between what was a purely quantitative result and what was a qualitatively adjusted result became less clear. As a result, the documentation regarding these adjustments has become more important since they may have had a significant impact on the allowance for credit losses reflected in the financial statements. In looking ahead to the end of the calendar year, while there is much to be hopeful in the world's response to the virus, much uncertainty remains, including the timing and speed of the forecasted economic recovery, which may differ based upon individual facts and circumstances.

By year end, calendar year public companies will have had three quarters of experience in developing the CECL estimate in an uncertain economic environment and with a remote work environment. They have taken the lessons learned over these reporting cycles and applied them to improve their related processes, controls, and models. Just because the original models developed to estimate expected credit losses under CECL may not have been calibrated for the dramatic change in the current economic environment, this does not mean that they are not fit for purpose for the "regular" environments in which they were initially designed to operate. Looking to 2021, many hope that economic forecasts and inputs will revert to the levels and scenarios contemplated when the models were designed, which may lessen, but not necessarily fully eliminate the need for qualitative adjustments to the model's output.

Throughout 2020 there has been an evolution of disclosures relating to the new credit loss estimate. This is typical of newly issued accounting standards as companies gain experience, have an opportunity to review the disclosures of their peers, and discuss financial information with users of their financial statements, including investors. CECL, coupled with the impact of the pandemic, is no exception. Disclosures on inputs into estimates, including macro-economic variables, and information on the use of multiple scenarios have evolved throughout the year. In addition, disclosures around credit risk management strategies, loan deferral programs, and the results of those programs have evolved and been well received by users of financial statements.

Disclosures, with a focus on helping users understand how the allowance for credit losses has changed, are expected to continue to evolve in 2020 annual reports and into 2021. The FASB has discussed disclosures and a few other topics based on the feedback received as part of the very early stages of their post implementation review of the new credit losses standard. Investors have articulated that information they received outside of the financial statements, such as quarterly earnings materials, played an important role in understanding what the key drivers for changes in the estimate were across reporting periods. Additionally, the lack of consistency and transparency in the CECL disclosures has made comparability challenging. This is not completely unexpected given that the CECL estimate is highly judgmental and complex in a benign environment, and even more so during a pandemic.

We expect increased focus by preparers and users on the CECL disclosures, and investors will likely seek ways to increase comparability across sectors. As companies prepare to close out year end results and the first chapter in the new credit losses guidance, they are well served by continuing to focus on providing decision useful information to users consistent with the intent of the CECL model.

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The IRS building in Washington. A few more of the Tax Cuts and Jobs Act regulations are likely to be finalized before Jan. 20.

Photographer: Andrew Harrer/Bloomberg

INSIGHT

The Year Ahead in International Tax

By Doug Poms, KPMG LLP

December 30, 2020

The current Treasury will likely try to finalize certain international regulations stemming from the Tax Cuts and Jobs Act regulations before Jan. 20 to avoid having them pulled by the new administration, writes Doug Poms of KPMG. The author also looks at what a new Treasury may do, such as reinstating a tradition of providing legislative proposals (often referred to as Green Book proposals) along with its annual proposed budget—including suggested legislative changes to international tax provisions.

With a surreal and challenging year coming to a close, and a new administration taking the reins in January, it is an interesting vantage point from which to write about the year ahead in international tax. In this article, I will focus more on the legislative and regulatory side of things, but much has been (and will continue to be) speculated regarding what will be the new Treasury's posture at the OECD, as the BEPS Pillars 1 and 2 negotiations strive to reach consensus by the middle of next year. It is only natural to wonder whether the U.S. change in administration may affect this timing.

We will likely see a few more of the TCJA (Tax Cuts and Jobs Act) regulations finalized before Jan. 20, but most of the international TCJA regs have already been finalized. Still out there are proposed tax code Section 163(j) regulations with a significant international component, and proposed GILTI domestic partnership regulations. It is also possible that certain long-anticipated proposed regulations such as the much-needed proposed PTEP (previously taxed earnings and profits) regulations will make the cut. The current Treasury knows that regulations not published in the Federal Register by Jan. 20 will almost certainly be pulled and will have to be reviewed, approved, and cleared again by the new administration. That generally will include review by an OMB Office of Information and Regulatory Affairs under new leadership.

Section 864(f), which provides for elective worldwide affiliated group interest expense allocation and apportionment, was last visited as part of the TCJA discussions and is set to take effect on Jan. 1. On that basis, Treasury and the IRS added a regulatory project for implementing these new rules in the 2020-21 priority guidance plan. Such guidance will surely be needed quickly once the statutory provision goes into effect.

The Biden Treasury's role in international tax policy may be affected by the outcome of the Georgia Senate races on Jan. 5. If control of the Senate is achieved by the Democrats, the prospects of new international tax legislation increase. Then, we may see proposed changes to the TCJA provisions, such as an imposition of a per country global intangible low-taxed income (GILTI) and perhaps a reduction or elimination of qualified business asset investment (QBAI) for GILTI and foreign-derived intangible income (FDII) purposes, as well as the consideration of new statutory provisions that would further encourage the conduct of business activity—particularly manufacturing—in the U.S. If Republicans maintain control of the Senate, Treasury regulations may be the most viable path for the Biden Administration to implement tax policy changes.

In this regard, the new Treasury may reinstate a tradition of providing legislative proposals (often referred to as Green Book proposals) along with its annual proposed budget—including suggested legislative changes to international tax provisions. Will the Biden Administration issue an executive order, like prior administrations have done, asking Treasury to identify recently issued regulations for further review? For example, Executive Order (EO) 13789 issued by the Trump Administration in 2017 led to re-examinations of the Section 385 and Section 987 regulations, among a few selected others that were issued in 2016.

Sure to be re-examined either formally or informally by the new administration are the GILTI high-tax election regulations, which were finalized in July 2020 with an accompanying set of proposed regulations that would largely conform the GILTI and Subpart F high-tax elections and propose a single unified election for both. Senate Finance Committee Ranking Member Ron Wyden charged those regulations were an overstep of Treasury's authority, and the Senator (along with Senator Brown) even proposed legislation that would amend Section 954(b)(4) to ensure that such provision is limited only to highly-taxed items of income that would otherwise constitute subpart F income (specifically, foreign base company income or insurance income). Still, it is not clear that the new administration would consider pulling those regulations, which interpret Section 954(b)(4) more broadly to apply to any item of income.

There are reasons to keep the GILTI high-tax exception around that might appeal to the Biden Treasury: (1) they are generally popular with business, (2) without them there is incentive for taxpayers to intentionally trip certain items of income into subpart F income characterization to benefit from Section 954(b)(4), and (3) if the GILTI rules become too strict, they might encourage inversions. Every administration since George W. Bush signed Section 7874 into law has taken a strong stance against inversions, and it is expected the new administration will follow suit. Alternatively, the Biden Administration may prefer to address any concerns with the GILTI high-tax exception, and the GILTI rules more generally, legislatively, if that is a realistic option.

Once the Biden Administration's top tax policy leadership positions are filled, we may start to see international tax regulations flowing again. What regulations might we see at that point? We may see Section 987 and Section 385 proposed regulations, if the new administration agrees with the current administration that proposed regulations in these areas are needed to reduce unnecessary taxpayer burden, a concern identified in response to EO 13789. We also could see finalization of the 2020 proposed foreign tax credit regulations that, among several proposed rules, would add a jurisdictional requirement to foreign tax creditability, thereby targeting digital service taxes and other extraterritorial taxes. Perhaps we will see finalization of the proposed cloud and QFPF (qualified foreign pension fund) regulations, both issued in 2019. We may also finally get needed general Section 245A guidance, Section 952 guidance, and Section 367(d) guidance for intellectual property brought back to the U.S., all regulatory projects that have been previously announced. Time will tell, as new competing priorities begin to emerge, but it looks clear that the new Treasury will have much to consider on the international tax regulatory front as soon as the Office of Tax Policy gets rolling again next year.

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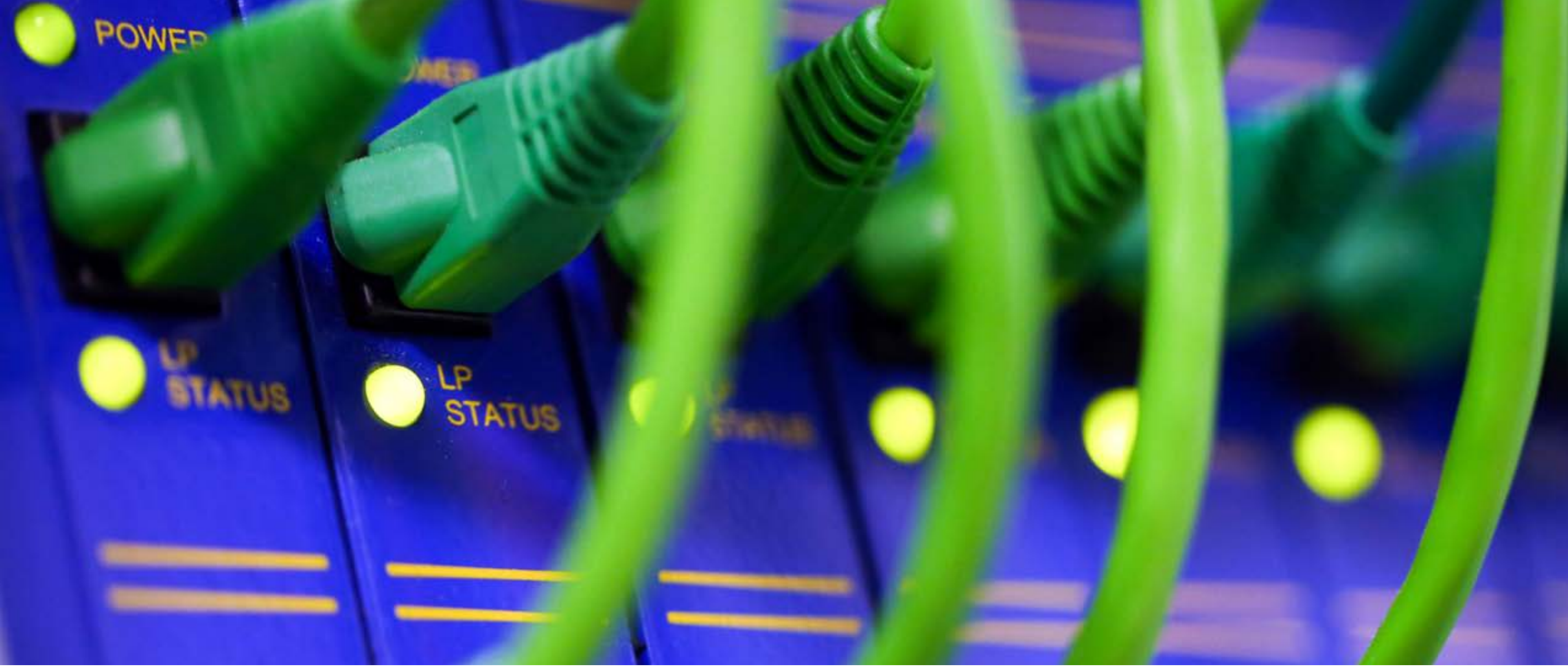

The embedded lease process can be simplified by technology, which should automate the flow of lease and non-lease components into lease accounting calculations.

Photographer: Chris Ratcliffe/Bloomberg

INSIGHT

Lease Accounting Woes? Expect Help from FASB and Technology

By Matt Waters, CoStar Group

December 24, 2020

The Financial Accounting Standards Board pushed back the implementation of new lease accounting standards to help private companies manage the challenges of the pandemic. However, the new requirements didn't go away. Matt Waters of CoStar explains how FASB is working to ease some difficulties and how technology can smooth the transition.

Companies struggling to meet ASC 842 requirements may have an easier road ahead. The Financial Accounting Standards Board and technology companies are both working to simplify compliance.

Most companies aiming to comply with the new accounting guidelines fall into three broad categories: public companies that have successfully transitioned to the new standard, public companies that have transitioned but are experiencing difficulty, and private companies that are just starting down the compliance path.

FASB and technology companies realize that path can be difficult and are taking steps to ease the pain. FASB is evaluating feedback from companies to understand their concerns about the requirements and is considering changes to make ASC 842 more manageable. Lease accounting software providers are automating processes that accountants have traditionally performed manually.

Below are some of the difficulties lessees face and possible solutions:

Incremental Borrowing Rates

ASC 842 requires lessees to use their incremental borrowing rates (IBRs) to calculate the lease liability balances for most leases. Some large public companies have found it difficult to set up a process to calculate and maintain records supporting their IBRs.

Private companies will have even more difficulties handling IBRs because they typically don't have the same level of in-house treasury expertise as public companies. So ASC 842 gives private companies the option to use the lower risk-free interest rate instead of an IBR. However, few use it because doing so increases calculated lease liabilities.

FASB has talked about revising the guidance to allow a rate that is easier to obtain than an IBR and is more in line with an actual corporate borrowing rate than the risk-free rate. One rate that could be an option is the yield on a BBB-rated bond.

Regardless of the rate companies choose, they can ease the burden of maintaining a list of rates by using technology. All accounting teams need to do is periodically collect the rates suitable for their company and upload them into their lease accounting software, which should automatically input the correct rate into lease accounting calculations.

Embedded Leases

Embedded leases exist when the use of an asset is included in a contract that is not typically called a lease. For example, a web-hosting service contract might include an asset, such as the sole use of identified server equipment, embedded in the contract. Some companies have found it difficult to apply lease accounting guidance to embedded leases, mainly because the consideration in a contract has to be split into lease and non-lease components. The lease components need to be handled one way, and the non-lease components need to be handled another.

Stakeholders in recent FASB lease accounting roundtables suggested simplifying rules regarding embedded leases. FASB may consider more simplification, but there are already measures companies can take to simplify accounting for embedded leases. They can apply a practical expedient to combine the lease and non-lease components and account for them all as lease components. And they can make a materiality assessment when considering whether ASC 842 rules apply to relatively small assets. The embedded lease process can also be simplified by technology, which should automate the flow of lease and non-lease components into lease accounting calculations.

ASC 842 vs. IFRS 16

Some companies must structure their lease accounting to comply with U.S. GAAP under ASC 842 and international accounting standards under IFRS 16. While the standards are aligned in many areas, one of the biggest areas of friction for dual reporting companies is accounting for rent increases that are tied to an index like the consumer price index (CPI). When rent increases are tied to an index, IFRS 16 requires a remeasurement, but ASC 842 does not permit a remeasurement.

FASB has already issued an exposure draft for a targeted improvement to ASC 842 that would give lessees the option to use the IFRS method. If finalized, this will ease the burden of companies that currently must conduct separate remeasurement processes to meet both U.S. and international reporting requirements.

Lease accounting software helps companies meet both standards, as it can automatically perform remeasurement calculations for each of them. Once the CPI increase is entered into the software, it should automatically remeasure U.S. GAAP and IFRS schedules according to a company's accounting policy. With automation in place, companies don't have to worry about the differences between the two standards.

Lease Modifications

Companies frequently make changes to leases, such as renewals, extensions, terminations, and partial terminations. When any of these changes occur, ASC 842 requires companies to remeasure lease accounting calculations. Each time a lease needs to be remeasured, it could take accountants hours to manually recalculate the ROU asset and lease liability. But technology automates the process.

Sometimes the slightest lease modification triggers the need to reclassify a lease from either a finance to an operating lease or vice versa. FASB is evaluating the rules and may make reclassification mandatory only when a modification substantially changes the lease agreement.

Accounting Rule Intersections

ASC 842 frequently intersects with other areas of accounting. ASC 410, which contains guidance on asset retirement obligations, and ASC 420, regarding exit or disposal obligations, have some similar time value of money calculations as those in ASC 842. Accountants can gain efficiencies by using the same tool for calculations required by all three standards.

To ease the complexities of meeting ASC 842 requirements, companies should watch for updates from FASB, weigh the benefits of applying any optional guidance or new practical expedients, and automate lease accounting to the fullest extent.

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