US Tax Overview

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Reasonable Cause Defense Waives Privilege?

In the pending Eaton transfer pricing advance pricing agreement (APA) case the court ordered that Eaton waived privilege and work product protections needed to withhold documents as a consequence of the company asserting the reasonable cause defense. The order states that when Eaton asserted the reasonable cause defense it put otherwise protected information in issue. This is a very surprising development. Attorney-client privilege is a long standing common law doctrine that applies not only in tax cases but also in nontax civil cases and criminal cases.

BEPS

A number of Base Erosion and Profit Shifting (BEPS) discussion drafts have been released, but little consensus has been reached. Countries like the U.K. are already jumping the gun by unilaterally enacting provisions that have not yet been agreed to by the BEPS participants. The whole point of the BEPS project is to develop a unified approach. In response to the U.K.'s newly enacted diverted profits tax, Amazon has announced that it will start booking sales income through the U.K. in order to avoid the punitive tax. Amazon's decision will likely encourage other counties to enact similar tax provisions. International taxation is becoming a land grab by countries trying to protect or expand their tax base. This jeopardizes the US tax base. US multinationals are caught in the middle and feel unfairly targeted by BEPS.

New US Model Treaty

The US Treasury Department released proposed changes to the US Model Income Tax Treaty designed to impact the BEPS project. The proposed revisions seek to address so-called stateless income, define and prohibit special tax regimes, and tax the foreign parents of domestic companies that are trying to invert. The five proposed rules address exempt permanent establishments, expatriated entities, special tax regimes, limitations on benefits and subsequent changes in the law.

Transfer Pricing

The IRS has been aggressively pursuing transfer pricing cases, especially those involving cost sharing buy-in payments. Rather than revising the regulations, which is often a lengthy and difficult process, the IRS is instead taking more cases to court. The newest large cost sharing buy-in dispute involves Microsoft, a transfer pricing dispute which could lead to a multi-billion-dollar income adjustment. The Microsoft dispute could be the largest transfer pricing dispute to date.

The trial for another large cost sharing buy-in case, *Amazon.com, Inc. v. Commissioner*, T.C. Dkt. 31197-12, took place in November. In the *Amazon* case, the IRS is using the same perpetual useful life argument that it argued and lost on in *Veritas v. Commissioner*, 133 T.C. 297 (2009), *nonacq*. The IRS faces an uphill battle in asserting that technology has a perpetual useful life, not only because of its previous defeat in *Veritas*, but also because of a common sense understanding of technological innovation. Technology becomes obsolete quickly.

Outside Law Firms Assisting the IRS in Examinations

The IRS has engaged Quinn Emanuel Urquhart & Sullivan LLP to assist in the Microsoft examination. Quinn will reportedly receive a fee of over $2M. Microsoft has challenged the IRS's authority to engage an outside law firm in the exam process. Sen. Orrin G. Hatch, R-Utah, Senate Finance Committee chair, demanded that the IRS immediately stop using outside law firms. Hatch questioned the IRS's decision to hire Quinn and criticized the fact that the IRS gave Quinn the authority to conduct sworn interviews and perform other actions that would give them access to confidential taxpayer information.

Economic Substance

The Federal Circuit held that the structured trust advantaged repackaged securities (STARS) transaction engaged in by BB&T Corp. lacked economic substance and upheld the denial of foreign tax credits in *Salem Financial, Inc. v. United States*, No. 14-5027, __ F. 3d __ (Fed. Cir. May 14, 2015), *aff'g in part, rev'g in part* 112 Fed. Cl. 543, 2014-1 UST.C 50,517 (2013). The court disagreed with the government's contention that a lack of profit potential before taking US tax benefits

into account conclusively establishes that the transaction lacked economic substance. The court, however, found that the STARS transaction was a contrived prepackaged transaction with no economic or business function other than to generate tax benefits. The Federal Circuit did, however, reverse the interest deduction issue allowing BB&T to deduct the loan interest.

Final Splitter Regulations

The § 909 foreign tax credit splitter rules have been finalized without any substantial changes to the 2012 temporary regulations. The splitter rules prohibit taxpayers from taking a foreign tax credit until the tax year in which the related income is taken into account. Treasury and the IRS are still considering how to address important mechanical issues relating to the calculation of related income and split taxes and how the taxes become unsuspended.

Inversions

The number of inversions that have taken place since Treasury's issuance of Notice 2014-52 has slowed down. Several companies nonetheless have completed or still plan to complete inversions. The Notice has, among other things, implemented a harsh anti-skinny down rule that targets any non-ordinary course distributions of the US company within the 36-month period preceding the inversion transaction. Skinny down distributions are reversed for purposes of applying the § 7874 ownership rules. The Notice also limits certain post-inversion tax avoidance transactions.