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Tax Court Rules for Amazon in $1.5B Transfer Pricing Dispute

By Mary Monahan and Ken Jones

On March 23, 2017, the United States Tax Court issued an opinion which represents a victory for Amazon.com, Inc. (Amazon) in the IRS’s attempt to assess approximately $1.5 billion of additional tax liability. The dispute arose from transfer-pricing adjustments made by the IRS with respect to a series of transactions by which Amazon and its domestic subsidiaries (Amazon US) established a European headquarters in Amazon Europe Holding Technologies SCS (AEHT), a Luxembourg subsidiary. AEHT was required to make a “buy-in” payment for specifically enumerated pre-existing intangibles and thereafter, AEHT made annual cost-sharing payments to compensate Amazon US for ongoing intangible development costs (IDCs), to the extent those costs benefitted AEHT. The IRS asserted that a discounted cash flow (DCF) method based on the enterprise value for Amazon’s entire European business, including subsequently developed intangibles, should be used to value the buy-in payment at $3.5 billion. With respect to the cost-sharing agreement, Amazon used a multistep allocation system to allocate costs from various cost centers to IDCs. Although the IRS accepted the cost-sharing allocation method in many respects, it determined that 100% of the costs captured in the “Technology and Content” cost center must be allocated to IDCs. The IRS also asserted that certain stock-based compensation costs must be included in the IDC pool. The Tax Court held that the IRS determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable, relying on its earlier decision in Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009), which held that no buy-in payment is required with respect to the value of subsequently developed intangibles where these assets are being paid for via cost-sharing. The Tax Court held that the comparable uncontrolled transaction (“CUT”) method—with certain adjustments—was the “best method” under the section 482 regulations. The Tax Court also held that the IRS had abused its discretion in determining that 100% of Technology and Content costs constituted IDCs. The court adopted Amazon’s cost-allocation method—with certain adjustments—to determine the proper allocation of these costs to IDCs. With respect to the stock-based compensation costs, the Tax Court followed its earlier decision in Altera Corp. v. Commissioner, 145 T.C. 91 (2015), which invalidated the regulations requiring such costs to be attributed to IDCs. The Altera decision is currently on appeal to the Ninth Circuit. The parties in Amazon will engage in computations under Tax Court Rule 155 to determine the amount of the tax adjustment under the Tax Court’s opinion. Following the conclusion of that process, which may take a year or more, the IRS will determine whether to appeal. The opinion adds to a series of IRS losses in high-profile transfer pricing disputes, including Veritas, Altera and Medtronic, Inc. v. Commissioner, T.C. Memo 2016-112. Given its lack of success thus far, it is unclear whether the IRS will rethink its approach to litigating transfer pricing cases.

IRS and US Life Insurance Industry Collaborating on New Reserving Issues

By Kriss Rizzolo and Graham Green

Faced with new state-based reserving requirements, US life insurance companies are working with the Internal Revenue Service (IRS) to develop guidance on how newly computed reserves will be treated for US federal income tax purposes. On January 31, 2017, the IRS announced that it will enter into an Industry Issue Resolution (IIR) program to develop guidance on these developing reserving issues for the life insurance industry. A more complete discussion of the IRS announcement, which was one of the 13 new campaigns recently announced by the IRS, is available in an Eversheds Sutherland Legal Alert. The goal of the IIR is to develop guidance that provides certainty for taxpayers while giving the IRS the benefit of industry input in developing the needed guidance. Resolving issues through guidance rather than through audits is a goal of the IRS as it seeks to deploy its diminished resources more effectively. The IIR collaboration process has already begun, and the interactions among the participants have been positive. The participants include industry representatives and the representatives of different components of the IRS, including
the attorneys responsible for developing guidance and IRS executives who oversee the examination of the tax returns of US insurance companies. The industry representatives currently are working to provide information requested by the IRS representatives for use in developing the guidance.

The new reserving methodologies, known as Principal-Based Reserving (PBR), went into effect on January 1, 2017, for state-based reserving purposes, but companies do not yet have guidance on how these reserves will be treated for US federal income tax purposes. Although the use of PBR is currently optional, PBR will generally be effective for all US life insurance companies starting January 1, 2020. Generally PBR is expected to lower reserves for most life insurance companies because the methodology accounts for each company’s individual loss experience in developing the state-mandated reserves for that company. Decreasing reserves would result in the recognition of taxable income by the affected insurance companies.

The announcement of the IIR is a positive step for the US life insurance industry as it begins to apply PBR and looks ahead to filing US federal income tax returns in 2018 that will reflect reserves computed under PBR for the first time.

The US Congress is expected to address comprehensive tax reform during 2017. Among the issues under consideration is the treatment of so-called “carried interests,” which are incentive allocations of private fund profits that are currently taxed as long-term capital gains under certain circumstances.

During the 2016 presidential campaign, President Trump proposed to tax carried interests as ordinary income rather than long-term capital gains. Whether any comprehensive tax reform package passed by Congress will ultimately adopt this proposal is uncertain. The Internal Revenue Service (IRS), however, is not waiting for tax reform to address what it considers to be an abusive practice common within the private equity industry where an investment manager will waive management fees owed by a fund in exchange for additional carried interests. If successful in this practice, a fund manager can effectively convert the management fees, which are taxed as ordinary income, into long-term capital gains.

In 2015, the IRS and Treasury proposed regulations under section 707 of the Internal Revenue Code that would make it more difficult for private fund managers to use management fee waivers. The proposed regulations are primarily directed at limiting the tax benefits of management fee waivers and other fee-waiver arrangements by raising the amount of risk a fund manager must take for a transaction to qualify for preferential tax treatment. These regulations are not effective until they are finalized, but IRS officials have stated that they think these rules reflect the current law.

More recently, according to Clifford Warren, special counsel in the IRS’s Office of Chief Counsel (Passthroughs and Special Industries), the IRS has been closely scrutinizing management fee waivers and has been seeking to issue guidance to restrict the practice. On March 3, 2017, at the Federal Bar Association Tax Law Conference, Warren said that the IRS is “very against” fee waivers because they are “extremely aggressive” and “commonly used,” and warned that taxpayers may not want to engage in this type of arrangement. Based on those and other comments, it appears that the IRS is now specifically instructing its auditors to look for investment fund management fee waivers that may not comply with the law.

Private fund managers should take care when using management fee waivers and carried interest arrangements given the proposed regulations and the current attitude of the IRS. In addition, private fund managers should review their existing arrangements to consider the risks that would be posed by a potential IRS audit. Private fund managers also should keep an eye on any comprehensive tax reform proposals as they develop to monitor the treatment of carried interests generally.
Poland: New VAT Penalties in Response to VAT Fraud
By Karolina Stawowska

One of the main goals of the Polish government is to fight against value-added tax (VAT) fraud, especially counteracting so called VAT carousels (VAT frauds within supply chains). To do so, two types of tax regulations were introduced into Polish law. Starting from July 2016, big enterprises have reported VAT evidence to the Ministry of Finance in a form of Standard Audit File for Tax (SAF-T). Medium/small enterprises are now obliged to report SAF-T for VAT effective January 2017.

Simultaneously, significant sanctions were imposed on taxpayers that issue false VAT invoices or deduct input VAT based on such documents. In addition to the repayment of input VAT that was incorrectly claimed and paying penalty interest, starting January 1, 2017, taxpayers will be subject to a new penalty of 100% of the deducted input VAT.

In other cases, underpayments in VAT identified by tax authorities during audits are subject to penalty interest and VAT penalties of 30% of the VAT underpayment.

Effective January 2017, a person who is guilty of issuing false invoices may be subject to liability under the Criminal Code (and in extreme cases may face up to 25 years of imprisonment).

Other changes to the VAT law introduced in January 2017 include if a business does not report VATable transactions in its VAT statements in a six-month period, the tax authorities can unregister the business for Polish VAT purposes. This rule is aimed to motivate the taxpayers to settle their VAT on a timely basis and to limit the number of correcting VAT statements.

Foreign entities registered in Poland should therefore pay particular attention to ensure VAT on non-routine transactions is accounted for in a timely way.

IRS Clarifies How to Run a Tight 401(k) Hardship
By Allison Wielobob and Brittany Edwards-Franklin

The Internal Revenue Service (IRS) has clarified employers’ burden for allowing employees to withdraw funds from their retirement accounts in the event of certain hardships. Many 401(k)-type plans, which allow employees to choose to save a portion of their earnings in a retirement account on a tax-favored basis, allow employees to access their retirement savings upon a showing of immediate and heavy financial need that cannot be met from other sources. And unlike taking a loan from the plan, participants do not have to pay back amounts used for a hardship withdrawal. Expenses that qualify may include costs arising from medical care, purchase of a principal residence, tuition, prevention of eviction from a principal residence, burial or funeral expenses, and repair of damages to a principal residence

The IRS requires substantiation that a distribution from a plan is for a qualifying hardship expense. In recent guidance to agents, the IRS outlined acceptable electronic processes for approving hardship withdrawals and clarified the types of documentation that a plan sponsor should request to substantiate hardship withdrawals from its 401(k) plan.

Despite past statements to the contrary, the IRS explained in the new guidance that an employee may “self-certify” an immediate and heavy financial need and provide a summary of his or her financial hardship in lieu of providing the plan sponsor with documentation of the hardship expense, such as medical bills, estimates or invoices. This means that the entirely electronic hardship withdrawal application processes offered by many third-party administrators may be acceptable for approving hardship withdrawals, subject to certain conditions.

Although this IRS guidance comes in the form of an internal memorandum on which taxpayers cannot rely, plan sponsors may no longer face pushback and potential penalties during plan audits because they use a simplified or electronic process for hardship withdrawal applications.
G20/OECD BEPS project – United Kingdom Implementation of Hybrid Mismatch Rules

By John Buckeridge and David Jervis

Action 2 (of 15) coming out of the G20/Organisation for Economic Co-operation and Development (OECD) project to tackle Base Erosion and Profit Shifting (BEPS) aims to prevent tax loss through hybrid mismatch cases.

The UK has enacted legislation to give effect to OECD recommendations which came into effect on January 1, 2017. Many other OECD countries either have enacted or are in the process of enacting similar legislation.

The legislation aims to tackle two main types of tax mismatch that typically arise in cross border transactions.

The first category involves cases where a payer in one country incurs a tax deductible expense, and a related payee of the expense payment in another jurisdiction is not required to bring the receipt into account for the purposes of computing its taxable profit, or has access to a favorable tax rate with regard to that type of payment (so that the receipt is undertaxed by reference to the “normal” tax rate applying to profits in its country). This result can happen in a number of ways and for a number of reasons. However, where such a transfer is identified in accordance with the legislation, the legislation prescribes a counteraction. This is referred to as a deduction/no inclusion.

The primary form of counteraction is to deny a deduction for the expense to the payer. However, if that has not happened, the tax authority of the recipient may treat the receipt as taxable where it otherwise would not have been. The UK applies the primary counteraction for preference, but if the payee is in the UK, and the payer jurisdiction does not deny the deduction, then it will apply the alternative treatment of recognizing the receipt.

A second category involves cases where two different taxpayers (typically related but in different jurisdictions) are able to claim a deduction for the same allowable expenditure. In such a case, the legislation determines which taxpayer normally entitled to the deduction should be denied the deduction. These are called double deduction cases.

The legislation also acts to deny a deduction to a permanent establishment (branch) in the UK if it might otherwise claim a deduction for a transfer (e.g., to its parent) that would not be recognized as income.

In general, any payments or transfers where there is this type of mismatch, even where the “mismatch” does not directly occur at the point of the cross-border payment (an “imported” mismatch), but somewhere else in the payment chain, is likely to be caught by this legislation. This is not always obvious where payment arrangements are complex – the UK’s tax authority, HMRC, has published draft guidance running to 400 pages to help interpret the legislation.

French Local Tax (CVAE)

By Jacques Mestoudjian

A company’s added-value contribution (CVAE) is payable by companies with a turnover exceeding €152,500. In practice, only companies with a turnover exceeding €500,000 are in the scope of the tax. The current French tax legislation provides that, for companies that are part of a tax-consolidated group, the CVAE rate applicable is determined based on the aggregate of the tax group members’ turnovers. This can lead to an increase of the CVAE individually owed by tax consolidated companies compared to the amount that would have been paid if they were not part of a tax consolidation.

Following a decision of the French Constitutional Court, this difference of treatment is to be determined under the equality before the law and public charges principle as provided by the French Constitution. The French Constitutional Court recently held (n°2016-571 QPC) as unconstitutional the exemption of the Company Income Tax Additional Contribution (3% tax) which benefit was limited to companies that were part of a tax-consolidated group. This ruling may help support a positive determination in relation to CVAE for companies that are part of a CVAE group.
On February 22, 2017, the Administrative Supreme Court referred a question to the French Constitutional Court on the constitutionality of the CVAE provisions with regard to the calculation of the rate for tax consolidated companies. The French Constitutional Court should provide its decision within a three-month period.

It is possible to file a claim with regard to the CVAE paid in 2016 before December 31, 2017.

However, it is recommended to put forward a claim before the French Constitutional Court to ensure such claim can benefit from such a favorable decision.

This claim could benefit companies generating a low standalone turnover compared to that of the tax consolidated group.

Please note that other arguments based on French legislation would also be available to support such claims.

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**Denmark: Consequences of the CJEU Decision in the Masco Denmark and Damixa Case**

Danish tax law prohibits thinly capitalized subsidiaries from deducting interest expenses. In order to avoid a situation in which interest payments are subject to double taxation in Denmark, the interest income received by a Danish parent company is exempt from taxation in this situation. However, Danish parent companies are not allowed to benefit from this exemption for interest income corresponding to interest disallowed at the level of a non-Danish subsidiary under the law applying to such non-Danish subsidiary.

The Court of Justice of the European Union (CJEU) held in the Masco Denmark ApS and Damixa ApS v Skatteministeriet case (C- 593/14) that the Danish legislation constitutes a tax disadvantage, because it may make it less desirable for a Danish parent company to exercise its freedom of establishment by deterring the parent company from setting up subsidiaries in other member states as opposed to setting up Danish subsidiaries. Such legislation therefore infringes the European Union (EU) principle of freedom of establishment under Article 49 of the Treaty on the Functioning of the European Union (TFEU).

This decision could enable tax relief claims in other European Union jurisdictions.

For example, in France, there is a limitation on the interest expense deduction on interest owed to direct shareholders and to some extent related parties (broadly speaking, the French parent company). Interest income corresponding to non-deductible interest taxed at the level of a French parent company (subject to corporate income tax (CIT)) can benefit from the parent-subsidiary dividend exemption. However, the French parent company cannot benefit from such regime for disallowed interest owed by a subsidiary established in another EU member state because of foreign legislation similar to the French legislation. Applying the same principle used in the Masco Denmark and Damixa case, this may be unlawful and may support a repayment claim for tax previously paid by such French parent company because the exemption was denied.

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**Italy Enacts Country-by-Country Report**

Action 13 of the Base Erosion and Profit Shifting (BEPS) project, issued by the Organisation for Economic Co-operation and Development (OECD), requires the development of rules on transfer pricing in order to grant transparency to provide Tax Authorities with information on the global allocation of income, economic activities and taxes paid in the various countries, according to a common template.

In particular, multinational groups having an overall revenue exceeding €750 million are required to file a Country-by-Country Report (CBCR), in order to communicate certain information to the relevant Tax Authorities about the countries where they operate businesses (inter alia, regarding economics and tax).
Oregon Considers Including Profits from More “Tax Haven” Countries

Oregon’s Legislative Assembly is considering expanding the state’s scope of taxation to encompass income earned by certain non-US subsidiaries. Specifically, a report by the Oregon Department of Revenue, considered in hearings in connection with proposed bill S.B. 155, would require taxpayers that report Oregon corporation tax to include income and losses from affiliates incorporated in certain countries that the state deems to be tax havens. The foreign affiliate must also share or exchange value with a related Oregon corporate tax filer, such as through centralized management or functional integration, which is commonly referred to as a unitary relationship.

The Oregon Legislative Assembly is evaluating whether to include Ireland, Jordan, Lebanon, Macau and the United Arab Emirates on the state’s statutory list of jurisdictions deemed as tax havens.

Oregon’s list of tax havens, promulgated under Oregon Revised Statutes § 317.716(1)(b), currently has 44 jurisdictions it considers to be a tax haven.

Similar legislation has recently emerged among states to address the taxation of foreign source income. Alaska, Connecticut, the District of Columbia, Montana, Oregon, Rhode Island and West Virginia have adopted tax haven legislation. The methods employed by the states to determine which jurisdictions to deem as a tax haven vary. Eight other states are considering adopting similar legislation in the 2017 legislative session.
Recent Developments Regarding the Establishment of a German VAT Group

By Dr. Stefan Diemer and Dr. Manuel Melzer

On January 25, 2017, the German Federal Supreme Tax Court (Bundesfinanzhof or BFH) published a decision regarding the prerequisites for establishing a value-added tax (VAT) group under German VAT law. Furthermore, the German tax authorities currently are preparing a decree in light of the recent decision of the BFH. Since establishing a VAT group does not require a contractual basis or an application to the tax office, but is established on a factual basis if the prerequisites under German VAT law apply, it is important to consider the latest developments regarding the establishment of a VAT Group, i.e., when filling positions of managing boards in a group.

According to German VAT law, a VAT group requires that the parent company (i) has a financial majority of the voting rights in the subsidiary company, (ii) is economically linked with the subsidiary company, and (iii) has the power to control the subsidiary company with regard to the ongoing business on the basis of an organizational integration of the subsidiary company which is actually carried out.

An organizational integration regularly applies if there is “personal identity” of the management boards of the subsidiary and the parent company, i.e., the same persons serve on the management boards of both companies. In exceptional cases, according to the BFH decision, an organizational integration can also apply if there is no such personal identity. In the recent decision, the prerequisite is that there are institutionally secured direct intervention opportunities under which the parent company can intervene in the core area of the subsidiary company’s ongoing management. In practice, this requires that the parent company be in a position to prove its decision-making authority against third parties (i.e., the tax office) and to hold the managing director of the subsidiary company responsible for violations of the instructions.

Under the recent decision of the BFH, an organizational integration also exists without personal identity of the management boards if, according to the employment agreement between the subsidiary company and its appointed managing director, the managing director of the subsidiary company must comply with the instructions of the shareholders’ meeting of the subsidiary company as well as the instructions of a third party who has an influence on the decision-making of the shareholders’ meeting and who is also managing director of the parent company with the power to represent the company alone.

Nonetheless, the safest way to establish an organizational integration is to create personal identity between the managing boards of the subsidiary and the parent company. However, the German tax authorities currently are preparing a decree, in the light of the recent decision of the BFH, which may provide additional safe ways to achieve an organizational integration. Such a decree must be followed by all local German tax offices.