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Digital taxation

OECD takes next step on BEPS 2.0 – Pillar One 'unified approach' released

On 9 October 2019, the OECD released a public consultation document outlining a proposal from the OECD Secretariat for a "Unified Approach" under Pillar One (Secretariat Proposal) of the ongoing project titled, *Addressing the Tax Challenges of the Digitalisaton of the Economy* (the Consultation Document).

The Secretariat Proposal does not represent the consensus view of countries that are members of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS). The Secretariat Proposal provides high-level suggestions on the scope of the new rules being developed under Pillar One, an approach to the new nexus concept, and an approach for new and revised profit allocation rules. It is intended to facilitate negotiations among the countries, with the aim of achieving the objective of a political agreement among the Inclusive Framework jurisdictions by the first half of 2020.

The Secretariat Proposal suggests that a "unified approach" under Pillar One should focus on large consumer-facing businesses. This would cover highly digitalized business models as well as businesses interacting with final customers. The Secretariat Proposal broadly defines large consumer-facing businesses as businesses that generate revenue from supplying consumer products or providing digital services that have a consumer-facing element. In this regard, the Secretariat Proposal notes that further work is needed to articulate the scope of the "unified approach," including how to define a consumer-facing business and how to deal with the supply of goods and services through intermediaries, the supply of component products and the use of franchise arrangements.

Moreover, the Secretariat Proposal indicates that some sectors should be carved out, citing extractive industries and commodities in particular. It also notes that there should be further consideration of whether other sectors (e.g., financial services) should be carved out. In addition, it indicates that consideration should be given to a size-base limitation (e.g., using the BEPS Action 13 country-by-country reporting €750 million revenue threshold).

The Secretariat Proposal includes a new nexus concept that is not dependent on physical presence and is largely based on sales. This new nexus is proposed to be separate from the existing permanent establishment concept, and it would operate regardless of whether taxpayers have an in-country marketing or distribution presence or sell through related or unrelated distributors.

Once it is determined that a jurisdiction has the right to tax profits of a nonresident enterprise under the new nexus approach, the next question would be how much profit should be allocated to that jurisdiction. The Secretariat Proposal describes a new profit allocation rule that is applicable to taxpayers within the scope of the "unified approach" and that would operate regardless of whether taxpayers have an in-country marketing or distribution presence (a permanent establishment or a subsidiary) or sell through unrelated distributors.

The proposal suggests that the new and revised profit allocation rules, taken together with existing transfer pricing rules, will need to be simple, avoid double taxation, and significantly improve tax certainty relative to the current position. The rules should be applicable to both profits and losses in order to avoid distortions. The Secretariat Proposal provides for a three-tier mechanism for allocating profits.

The three-tier mechanism would include a formulary approach if there is no nexus under existing principles. Revised profit allocation rules would apply where there is already a nexus in the market jurisdiction under existing rules.

The Secretariat Proposal acknowledges that further technical work is required and includes an annex with a series of specific questions for public comment on significant policy, technical and administrability issues.

Interested parties are invited to submit comments on the Consultation Document no later than 12 November 2019. The OECD will hold a consultation meeting in Paris on 21 and 22 November 2019 to give stakeholders an opportunity to discuss their comments with the Inclusive Framework countries.

The Consultation Document does not address the Pillar Two work on development of new global minimum tax rules. However, the OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, which was released on 9 October 2019 in advance of their 17 October 2019 meeting in Washington, notes that progress is being made on the Pillar Two work, with agreement reached on the design of new rules to operate as a top-up to a fixed minimum rate of tax that will be agreed

G20 affirms OECD two-pillar approach; OECD official offers timeline

G20 Finance Ministers and Central Bank Governors issued a press release on 18 October following their Washington, DC meeting, expressing support for the OECD's two-pillar approach and ongoing progress on the tax challenges arising from the digitalization of the economy. The group affirmed their support for a consensus-based solution and stressed the importance of the Inclusive Framework on BEPS, agreeing to the outlines of the architecture by January 2020, with a final report to be delivered by the end of 2020.

In mid-October, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, elaborated on the timeline. He was quoted as saying the organization hopes to cement the details of its digital tax proposal in January, with a political agreement reached in June 2020. If agreement can be reached in summer 2020, Saint-Amans said the implementation phase would begin. Saint-Amans added, "Then the question is, what will be the instrument to implement it and how much time to develop [rules]? But the goal is to move as fast as possible if we have political agreement. For the time being we are focusing on political agreement."

on once other key design elements of the minimum tax rules are finalized. The OECD Secretariat has indicated that a consultation document on this topic will be released in November 2019, with a consultation meeting to be held in December 2019.

The report to the G20 also includes a brief outline of preliminary findings in the Impact Assessment of the Pillar One and Pillar Two proposals. The report indicates that the two pillars taken together are expected to result in an overall increase in global tax revenues with a redistribution of taxing rights. It further indicates that investment hubs with high levels of residual profits would be expected to see a reduction in their tax base. The report does not indicate which countries are expected to see this adverse impact.

The complex issues underlying both the Pillar One and Pillar Two proposals will continue to be the subject of both policy and technical discussions among the Inclusive Framework jurisdictions through at least 2020. The Consultation Document underscores that the international tax changes being contemplated will have implications well beyond digital businesses and digital business models.

These proposals could lead to significant changes to the overall international tax rules under which multinational businesses operate and could have important consequences in terms of businesses' overall tax liability and countries' tax revenues.

Treasury and IRS news

Treasury issues final regulations removing Section 385 documentation requirements, issues notice of proposed rulemaking for treating some interests as debt

On 31 October 2019, the Treasury Department issued final regulations (TD 9880) under Section 385 removing the minimum documentation requirements that must be satisfied to treat certain financial arrangements among related parties as indebtedness for federal tax purposes. The final regulations adopt the proposed regulations (REG-130244-17) without any change.

At the same time, Treasury issued an advance notice of proposed rulemaking (ANPR) (REG-123112-19) that would modify the so-called Distribution Regulations, which may treat an issuance of a debt instrument in a distribution (or similar) transaction as stock. The Distribution Regulations include a funding rule that treats as stock a debt instrument that is issued as part of a series of transactions that achieves a similar result. The most noteworthy proposed modification would remove the funding rule's per-se 72-month period for a more "facts and circumstances" test. According to the ANPR, when issued the proposed regulations would treat the debt as stock only if its issuance has sufficient factual connection to a distribution to a member of the taxpayer's expanded group or an economically similar transaction.

While determining that the Distribution Regulations remain necessary, Treasury intends that the proposed regulations make the regulations "more streamlined and targeted." Treasury further intends the proposed regulations to apply to tax years beginning on or after the date of publication of adopting those rules as final regulations in the Federal Register.

IRS announces taxpayers can still rely on expired temporary Section 385 recharacterization rules

In Notice 2019-58, released 11 October 2019, the IRS announced that taxpayers may continue to rely on the October 2016 proposed regulations on characterizing certain corporate interests as stock or debt under Section 385, even though the related temporary regulations expired on 13 October 2019.

The expiration of a significant portion of the overall regulatory framework is expected to raise numerous questions regarding ongoing taxpayer compliance with the regulations that remain in place.

As background, the 2016 proposed regulations consisted of a cross-reference to the temporary regulations issued at the same time as the final Section 385 regulations (TD 9790).

The final and temporary regulations (i) established extensive documentation requirements that must be satisfied for a debt instrument to constitute indebtedness for US federal tax purposes (Reg. Section 1.385-2); and (ii) recharacterized a debt instrument issued after 4 April 2016, as stock if the instrument was issued as part of a transaction listed in Reg. Section 1.385-3 and Reg. Section 1.385-3T. Proposed regulations were subsequently issued proposing to revoke the documentation rules and were finalized on 31 October (see previous story for details).

The October 2016 proposed regulations were to apply to tax years ending on or after 19 January 2017, and do not expire. Notice 2019-58 made clear that taxpayers may rely on the October 2016 proposed regulations for periods after the temporary regulations expire until further notice is given, provided taxpayers consistently apply the proposed rules in their entirety.

Significant portions of Reg. Section 1.385-3 that were final, including the essential recharacterization rules of Reg. Section 1.385-3(b), are not affected by Notice 2019-58.

Those portions of the Section 385 regulations that have expired (for which the October 2016 proposed regulations remain in place) generally define the "qualified short-term debt" exception and address the treatment of controlled partnerships.

In addition, Reg. Section 1.385-4T, which provided special rules for consolidated return groups, also expired. Thus, these subject areas are likely to be most affected by the expiration of the temporary regulations.

JCT releases Blue Book for 115th Congress; TCJA covered by earlier release

The Congressional Joint Committee on Taxation staff released the *General Explanation of Certain Tax Legislation Enacted in the 115th Congress* (JCS-2-19) on 31 October. Colloquially known as the Blue Book (2019 JTC Blue Book), the publication includes a description of all tax legislation enacted in the 115th Congress, with the exception of the *2017 Tax Cuts and Jobs Act* (Public Law 115-97), which was covered in a separate General Explanation released in December 2018.

IRS issues proposed regulations and Rev. Proc. 2019-40 on repeal of Section 958(b)(4)

The US government on 1 October, released proposed regulations that would limit the impact of the repeal of Section 958(b)(4) in determining the controlled foreign corporation (CFC) status of a foreign corporation when applying certain provisions of the Code. Before its repeal by the *Tax Cuts and Jobs Act*, Section 958(b)(4) prevented a US subsidiary from being treated as owning stock in a foreign-owned brother-sister subsidiary for purposes of determining whether the brother-sister foreign subsidiary was a CFC.

The proposed regulations do not provide broad relief from the repeal of Section 958(b)(4), but instead offer targeted relief by effectively causing select Code provisions to apply as if Section 958(b)(4) had not been repealed. The proposed regulations notably would:

- Modify Section 267(a)(3) to allow a taxpayer to deduct accrued but unpaid amounts (other than interest) owed to a CFC when (i) the payment is not subject to withholding tax under a treaty, and (ii) the CFC does not have any US shareholders (as defined in Section 951(b)) that own (within the meaning of Section 958(a)) stock of the CFC
- Determine CFC status without regard to the repeal of Section 958(b)(4) for purposes of the Section 1297(e) Passive Foreign Investment Company asset test
- Determine CFC status without regard to the repeal of Section 958(b)(4) for purposes of the CFC foreign tax credit look-through rules under Section 904(d)(3)
- Provide additional rules, including narrowing the gain recognition agreement triggering event exception in Reg. Section 1.367(a)-8(k)(14) and determining CFC status for purposes of applying Section 332(d)(3) to the liquidation of an applicable holding company

The proposed regulations generally would apply on or after 1 October 2019. For taxable years before taxable years covered by the regulations, taxpayers generally may apply the rules in the final regulations to the last taxable year of a foreign corporation beginning before 1 January 2018, if certain conditions are met.

On the same day, the IRS also issued Rev. Proc. 2019-40 related to the repeal of Section 958(b)(4). According to the IRS, the revenue procedure "limits the inquiries required by U.S. persons to determine whether certain foreign corporations are controlled foreign corporations" and "allows certain unrelated minority U.S. shareholders to rely on specified financial statement information to calculate their subpart F and GILTI inclusions and satisfy reporting requirements" for certain CFCs if more detailed tax information is unavailable.

The revenue procedure, which provides a series of safe harbors, would apply generally as of the last taxable year of a foreign corporation beginning before 1 January 2018.

IRS proposed rules address tax consequences of elimination of LIBOR, other interbank offered rates

In light of the pending phaseout of the London interbank offered rate (LIBOR) and variant interest rates, the IRS has issued proposed regulations (REG-118784-18) addressing tax issues resulting from the transition to the use of reference interest rates other than interbank offered rates (IBORs) in debt instruments and other contracts.

IBORs, including the US-dollar LIBOR (USD LIBOR), are planned to be phased out by the end of 2021, which has far-reaching financial and tax implications because the USD LIBOR is widely-used as a reference rate in a broad range of financial instruments. The Alternative Reference Rates Committee (ARRC) of the Federal Reserve, tasked with selecting alternative rates, selected the Secured Overnight Financing Rate (SOFR) as the replacement for USD LIBOR.

Other jurisdictions have selected other reference rates to replace IBORs for their respective currencies, including the Sterling Overnight Index Average (SONIA) to replace British pound sterling LIBOR, the Tokyo Overnight Average Rate (TONAR) to replace yen LIBOR and the Tokyo Interbank Offered Rate, and the Swiss Average Rate Overnight (SARON) to replace Swiss franc LIBOR.

In connection with the IBOR transition, the ARRC requested guidance from the US Treasury Department on tax issues associated with the elimination of IBORs and the transition to other rates such as SOFR. Because the new reference rates differ from the IBORs they are intended to replace, it is expected that contracts will generally provide for a change to the spread over the interest rate (a spread adjustment) or a one-time payment for the change in value. ARRC also requested guidance on issues resulting from any spread adjustments or change-in-value payments.

Tax issues resulting from the change of the terms of existing debt instruments and other contracts to non-IBOR rates arise under various sections of the Internal Revenue Code.

To facilitate the transition away from IBORs and minimize resulting market disruption, the IRS issued the proposed regulations with an aim to reduce associated tax uncertainty and taxpayer burden. To this end, the proposed regulations include revisions and additions to the rules under Sections 1001, 1275, 860G and 882. Taxpayers may rely on the proposed rules before final regulations are issued to the extent specified in the proposed regulations.

Given the number of financial instruments that reference IBOR (almost $200 trillion reference USD LIBOR alone), the demise of this benchmark will affect numerous taxpayers. To that end, the proposed regulations provide welcome guidance on one of the most pressing issues – whether the transition to a new interest rate benchmark will result in the realization of gain or loss on an IBOR-based instrument. Nonetheless, the proposed regulations leave many questions unanswered, including:

- The treatment of the one-time payment to compensate the other party upon transition to new benchmark.
- The treatment of a modification between related parties where the fair market value requirement of the qualified rate definition is not met.
- Continued qualification for integrated transaction treatment.

Because the transition from IBOR may impact debt instruments, as well many non-debt instruments that reference IBOR (including interest rate swaps, cross-currency swaps and equity swaps) taxpayers need to begin identifying their IBOR-based instruments. Once those transactions are identified, taxpayers will need to consider how they will transition those instruments from IBOR and how such transition will be treated under the proposed regulations, including any impacts to GAAP accounting for the tax consequences under ASC 740.

New US cryptocurrency tax guidance addresses some open questions, leaves others unanswered

On 9 October 2019, the IRS issued guidance in the form of a revenue ruling and frequently asked questions on the tax treatment of cryptocurrency transactions. In Revenue Ruling 2019-24, the IRS ruled that a "hard fork" (e.g., when one cryptocurrency becomes two) will not cause taxpayers to recognize income under Section 61. Taxpayers will recognize ordinary income, however, if they receive new units of cryptocurrency (i.e., an "airdrop") following the hard fork.

The ruling left many issues unanswered, however. No determinations have been made on the applicability of the wash sale rules, de minimis exceptions, the tax treatment of initial coin offerings and security token offerings, the tax treatment for those receiving tokens in connection with providing proof of stake, or how cryptocurrency interacts with international tax rules. In addition, guidance is needed on whether merely trading cryptocurrencies in the United States can give rise to income that is effectively connected with a US trade or business.

In frequently asked questions (FAQs), the IRS expands on its 2014 cryptocurrency guidance (Notice 2014-21) by providing more examples of (i) when taxpayers recognize gain or loss on an exchange of cryptocurrency, (ii) how to calculate basis in cryptocurrency, and (iii) when taxpayers recognize income on other cryptocurrency-related transactions.

The IRS has also started adding references to virtual currency to a few forms and their instructions. A taxpayer must report ordinary income from virtual currency on Form 1040, *U.S. Individual Tax Return*, Form 1040-SS, Form 1040-NR, or Form 1040, *Schedule 1, Additional Income and Adjustments to Income (PDF)*, as applicable. Taxpayers must calculate and report capital gain or loss from virtual currency and other capital transactions in accordance with IRS forms and instructions, including Form 8949, *Sales and Other Dispositions of Capital Assets*, and then summarize capital gains and deductible capital losses on Form 1040, *Schedule D, Capital Gains and Losses*.

A recently released second draft of Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, includes the following question: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" The wording is similar to the question included on Form 1040, Schedule B, asking taxpayers whether they have interests in offshore accounts. This suggests that the IRS's enforcement of cryptocurrency reporting could resemble its enforcement of offshore accounts reporting.

Now that guidance has been released, taxpayers should review previously filed returns to confirm that they accurately reported gains and losses from cryptocurrency transactions. Taxpayers might need to consider amending returns to comply with the new guidance. For example, taxpayers that failed to include the FMV of cryptocurrencies airdropped after a hard fork should consider whether they must amend a previously filed tax return.

In addition, taxpayers should consider whether an accounting method change is warranted for previously filed tax returns, as FAQ 37 allows taxpayers to either specifically identify or default to FIFO when computing basis for cryptocurrency sales or exchanges. In the absence of guidance, some taxpayers may have used an impermissible accounting method to compute tax basis. Taxpayers that may have used an impermissible method of accounting should consider applying for a change of accounting method.

Taxpayers and tax return preparers should continue monitoring progress on Form 1040, Schedule 1, *Additional Income and Adjustments to Income*. A 30-day comment period on the schedule began on 11 October 2019. If the form is finalized as currently drafted, taxpayers and tax return preparers may have to file Schedule 1 solely to indicate whether they engaged in cryptocurrency transactions. While a taxpayer with no cryptocurrency transactions should not have an issue, taxpayers that must answer "yes" and have no other reason to file Schedule 1 could accidentally fail to respond to the question.

IRS Chief Counsel Advice concludes 952(c) election to include otherwise excludible insurance income in subpart F income of CFCs' US shareholders is obsolete

In a Chief Counsel Advice Memorandum (AM 2019-001 or GLAM) released on 4 October 2019, the IRS provides a legal analysis for determining the availability of the election under

Section 952(c)(1)(B)(vii)(I) (the 952(c) election). The 952(c) election would permit a US shareholder of a controlled foreign corporation (CFC) to include in subpart F income certain insurance income that would otherwise be excluded because it was attributable to the CFC's insurance activities in the country in which the CFC was created or organized (same-country exception).

Ultimately, the GLAM concludes that the 952(c) election "has been inoperable since 1998" and was made obsolete in 2015, even though the 952(c) election actually remains in the Internal Revenue Code.

The GLAM explains that the subpart F rules applicable to insurance companies have undergone significant legislative changes since 1986. The *Tax Reform Act of 1986* enacted the same-country exception; another legislation package in 1988 enacted the 952(c) election; and the current version of the subpart F rules for insurance companies (the active financing exception (AFE)) was enacted in 1998. Because the 952(c) election "was a creature of" the same-country exception rules "that became defunct after AFE was made permanent" in 2015, the GLAM concludes that the 952(c) election is obsolete.

The IRS's arguments for finding the 952(c) election obsolete appear to be unsupported in legislative history or other authorities. They also do not address other equally or more valid arguments for finding that the 952(c) election remains available.

OECD news

OECD releases sixth batch of peer review reports on Action 14

On 24 October 2019, the OECD released the sixth batch of peer review reports relating to the implementation by Argentina, Chile, Colombia, Croatia, India, Latvia, Lithuania and South Africa of the BEPS minimum standard on Action 14 (*Making Dispute Resolution Mechanisms More Effective*). Colombia, Latvia and Lithuania had also requested that the OECD provide feedback concerning their adoption of the Action 14 best practices, and the OECD also therefore released three accompanying best practices reports.

Overall, the reports conclude that five of the eight assessed jurisdictions meet the majority or most of the elements of the Action 14 minimum standard. Latvia meets slightly more than half of the elements of the Action 14 minimum standard, and India meets half of the elements. Colombia meets fewer than half of the elements of the Action 14 minimum standard. In the next stage of the peer review process, each jurisdiction's efforts to address any shortcomings identified in its Stage 1 peer review report will be monitored.

Puerto Rico's new transfer pricing study option could allow full deduction of related-party expenses

Taxpayers may be able to fully deduct related-party expenses in Puerto Rico if they submit a transfer pricing study with their income tax returns.

Although the PR Internal Revenue Code generally disallows an income tax deduction for 51% of the expenses a taxpayer incurs from related persons not engaged in a trade or business in Puerto Rico, a change in the law eliminated this disallowance for tax years commencing in 2019 and later — as long as the taxpayer submits, along with its income tax return, a transfer pricing study that covers the operations carried out within Puerto Rico. Entities interested in submitting transfer pricing studies with their Puerto Rico returns should be sure to take into consideration the time required to have a study completed.

Because no regulations or administrative guidance has been issued by the Puerto Rico Treasury Department (PRTD) at this time, there are unanswered questions and aspects of this new rule that remain unclear. Unofficial statements made by PRTD tax policy officials in public forums have alluded that, in the absence of administrative guidance, a transfer pricing study complying with IRC Section 482 should be sufficient to support full deductibility of related-party expenses under the Code. Nonetheless, this matter should be monitored closely since the PRTD reserves the right to issue an official interpretation on the application of the new transfer pricing option at any time.

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