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In this issue

Treasury and IRS news

IRS issues proposed regulations addressing cloud-based and other digital transactions

On 9 August 2019, Treasury and the IRS released proposed regulations (REG-130700-14, Prop. Reg. Section 1.861-19) addressing cloud-based transactions and other transactions involving digital content, such as gaming and social media. Treasury also proposed regulations that would amend current Reg. Section 1.861-18, which provides rules governing transactions involving computer programs.

These proposed rules represent Treasury's first significant attempt to grapple with cloud computing and related digital tax issues. The proposed regulations reflect an incremental approach by Treasury to create a flexible and coherent framework to resolve a host of complex and dynamic tax issues raised by cloud computing transactions and the digital economy. The proposed regulations identify several critical gating issues regarding the classification of cloud computing and other digital transactions, such as characterizing cloud transactions as either the provision of a service or the lease of tangible or intangible property.

The proposed regulations would modernize and expand the software regulations under Reg. Section 1.861-18 to cover "digital content." They would also clarify certain open questions, such as the source of income for transactions involving sales of copyrighted articles and the scope of the rights to publicly display or make a public performance.

Prop. Reg. Section 1.861-18 would apply to transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final. Prop. Reg. Section 1.861-19 would also apply to cloud transactions entered into in tax years beginning on or after the date of publication of the Treasury Decision adopting the regulations as final.

With respect to the service or lease characterization determination addressed by Prop. Reg. 1.861-19, the approach in the proposed regulations is generally consistent with how many taxpayers analyze transactions involving digital content and cloud computing transactions. Specifically, the cloud regulations expand on Section 7701(e), which provides factors that distinguish between services and leasing transactions, and common law authorities.Thus, the proposed regulations, if finalized in current form, are unlikely to cause significant disruption or rethinking of reporting positions on income characterization.

The new sourcing rule for sales of digital content through an electronic medium (copyrighted article transaction), however, is a departure from the existing rules for sourcing of

French President comments on new Digital Services Tax

At the conclusion of a three-day G-7 Summit meeting in Biarritz, France, French President Emmanuel Macron commented on the future of France's Digital Services Tax (DST), which entered into force on 25 July 2019. Speaking at the post-Summit press conference with President Trump on 26 August, President Macron said that the French DST would be eliminated, and any DST amounts that are paid by multinational companies would be reimbursed in some way, if a new international tax system with respect to digital services is put in place through the OECD process.

The French DST was enacted in July 2019 with retroactive effect to 1 January 2019 and taxpayers are currently preparing to submit an advance payment in November 2019. The United States had charged that the proposed 3% tax targeted certain US multinationals and launched a probe under Section 301 of the *Trade Act of 1974*. President Trump also threatened retaliatory action on certain French imports, including wine. US officials have not commented on the French statements that the DST will be eliminated and some form of reimbursement provided when new international tax rules covering digital services are in place.

The US Trade Representative held a public hearing on 19 August 2019 on its Section 301 investigation of the DST. According to press reports, the representatives of various US technology companies testifying at the hearing were unanimous in opposing France's DST, noting it could result in double taxation and calling it discriminatory and against tax treaty practice.

inventory products (generally where right, title and interest transfer from seller to buyer). The proposed regulations primary approach for sourcing such income — i.e., the location where users download the digital content — is likely to be burdensome and difficult for taxpayers to track, forcing some taxpayers to effectively rely on the secondary rule (customer location based on sales data) to determine source.

IRS begins to increase enforcement efforts in cryptocurrency space

The IRS has begun sending letters (Letter 6173, Letter 6174, or Letter 6174-A) to approximately 10,000 taxpayers with regard to cryptocurrency transactions. This action signals a serious step-up in enforcement efforts by the IRS in the cryptocurrency space since the 2 July 2018 announcement of the virtual currency campaign, that indicated that the IRS was not contemplating a voluntary disclosure program specifically to address tax non-compliance involving virtual currency.

Additionally, some taxpayers are reporting receipt of CP2000 notices from the IRS, which assert that the taxpayer has underpaid tax with respect to cryptocurrency transactions. Unlike Letters 6173, 6174, and 6174-A, the CP2000 notice contains the IRS's calculation of underpaid tax, plus interest.

The IRS has issued limited guidance on the taxation of cryptocurrencies, namely Notice 2014-21. The Notice generally treats "convertible virtual currency" as property, rather than currency, for federal tax purposes.

Gain or loss on cryptocurrency transactions is calculated in the same manner as other property sales: gain/loss = amount realized − adjusted basis. Both the amount realized and adjusted basis must be converted to US dollars for federal tax reporting purposes. The character of the gain/loss depends on whether the cryptocurrency is a capital asset in the taxpayer's hands.

By issuing these letters, the IRS is apparently giving taxpayers a chance to amend returns to correct underreported income related to, or improper reporting of, their cryptocurrency transactions. Taxpayers who do not take advantage of this opportunity risk exposure to increasingly aggressive (and potentially less forgiving) future IRS enforcement, including possible imposition of penalties and interest charges on underreported tax. Although the letters are not actual examinations, failure to respond may result in the IRS initiating an audit.

In addition, taxpayers should be aware that while gains/losses realized in connection with the sale or exchange of cryptocurrencies should generally be recognized for federal income tax purposes, additional tax issues arise in connection with cryptocurrencies for which little guidance is currently available.

For example, little guidance is available on the impact of a "fork" in a particular blockchain that could give rise to two different digital assets (and the need to assess taxability of any new assets resulting from such fork, as well as potential basis adjustments). Additionally, little guidance is available on transactions involving assets received pursuant to an "airdrop" in which the owner of a digital wallet in one cryptocurrency is given rights to a new wallet/cryptocurrency as a method of broadly distributing the new cryptocurrency.

There are numerous other issues impacting those trading or investing in cryptocurrencies for which little guidance is available. Accordingly, both taxpayers and their advisors should consult with professionals that have experience in dealing with these matters.

IRS will allow domestic partnerships, S corps to apply proposed GILTI regulations before 22 June 2019

The IRS has indicated that for tax years ending before 22 June 2019 it will permit domestic partnerships and S corporations to apply the hybrid approach to the treatment of a domestic partnership that is a US shareholder of a controlled foreign corporation that was included in the proposed Global Intangible Low-taxed Income (GILTI) regulations. This approach was included in proposed GILTI regulations published on 10 October 2018 but was not adopted in final GILTI regulations published on 21 June 2019.

More specifically, on 22 August 2019 the IRS issued Notice 2019-46, which announced that Treasury and the IRS plan to issue regulations that will permit domestic partnerships and S corporations that are US shareholders of a controlled foreign corporation to apply proposed Reg. Section 1.951A-5 for tax years ending before 22 June 2019. The forthcoming regulations will provide relief from possible compliance burdens resulting from differences between the proposed and final GILTI regulations. Until the regulations are issued, taxpayers may rely on the Notice.

The Notice also includes penalty relief for domestic partnerships and S corporations that acted consistently with Prop. Reg. Section 1.951A-5 on or before 21 June 2019 but file a tax return consistent with the final regulations under Reg. Section 1.951A-1(e). Certain notification and reporting requirements apply.

President Trump reportedly signed ratification instruments to US tax protocols

The tax press in early August reported that President Trump signed the instruments of ratification to four tax protocols amending US treaties with Luxembourg, Switzerland, Japan, and Spain. The US Senate gave its advice and consent to approve the long-delayed agreements on 16 and 17 July 2019.

Transfer pricing news

US Court of Appeals affirms Tax Court's decision in *Amazon* case

The US Court of Appeals for the Ninth Circuit on 16 August 2019 released its opinion in *Amazon.com, Inc. & Subsidiaries v. Commissioner*. Ruling on the Commissioner's appeal, the court affirmed the Tax Court's decision of 23 March 2017. In that decision, the Tax Court concluded that, under the then-applicable transfer pricing regulations, the definition of "intangible" does not include residual business assets, such as the value of employees' experience, education and training (known as "workforce in place"), nor a culture of innovation, going concern value, goodwill and other unique business attributes and expectancies (which the parties refer to as "growth options").

The Court of Appeals went out of its way to point out that its opinion interprets the definition of "intangible property" under the transfer pricing regulations promulgated in 1994 and 1995 and not the subsequently issued 2009 regulations or the statutory amendment introduced with the *Tax Cuts and Jobs Act of 2017* (TCJA).

In Footnote 1 at the beginning of the opinion, the Court of Appeals explicitly stated that, if the case were governed by the 2009 regulations or by the 2017 statutory amendment of the TCJA, the Commissioner's position would undoubtedly be correct.

While the opinion interprets the outdated 1994/1995 transfer pricing regulations, it also offers several insights for taxpayers that go beyond their temporal scope. The statement in Footnote 1 may be considered dicta and thus not legal precedent, but taxpayers should still consider the potential implications on post-2009 cost-sharing arrangements.

In 2009, Treasury issued temporary regulations broadening the scope of what is included in the buy-in payment upon entering a cost-sharing arrangement.

In the TCJA, Congress amended the definition of intangible property set forth in Section 936(h)(3)(B) to explicitly include workforce, goodwill and going concern. While the Ninth Circuit opinion clearly differentiates its conclusions from subsequent rule changes, there are potentially three separate periods of guidance for taxpayers to consider as they evaluate the impact of the opinion on their specific facts and circumstances.

IRS withdraws "*Altera* Memo" Directive on cost-sharing arrangement stock-based compensation

In light of the US Ninth Circuit's decision in June 2019 reversing the Tax Court's 2015 decision in *Altera v. Commissioner*, the IRS Large Business and International Division (LB&I) formally withdrew the so-called *Altera* Memo (Directive LB&I-04-0118-005) on 31 July 2019 in LB&I-04-0719-008 (Withdrawal of Directive LB&I-04-0118-005).

The LB&I Commissioner noted that examiners should continue applying Reg. Sections 1.482-7A(d)(2) and 1.482-7(d)(3), including opening new examinations regarding cost-sharing arrangement (CSA) stock-based compensation (SBC) issues. LB&I stated that "these issues may be factually intensive, and transfer pricing teams should develop the facts to support their analysis and conclusions."

IRS issues revised FATCA Publication 5188

The IRS in August 2019 released a revised version of Publication 5188 on reporting FATCA (*Foreign Account Tax Compliance Act*) data. The International Data Exchange Services (IDES) user guide provides information for financial institutions, direct reporting non-financial foreign entities, sponsoring entities, non-global intermediary identification number filers, and Host Country Tax Authorities who transmit data through the IDES.

The withdrawal memo also noted that IRS Issue Teams should consult the Practice Network and Counsel for support in analyzing the issue and that LB&I will monitor further developments related to the Ninth Circuit's decision.

On 22 July 2019, Altera Corporation filed a petition for a rehearing of the *Altera* case *en banc*. The petition requests that the Ninth Circuit rehear its challenge of the 2003 cost-sharing regulations and reverse the Ninth Circuit's opinion of 7 June 2019.

OECD news

OECD releases United States Stage 2 peer review report on implementation of Action 14 minimum standard

On 13 August 2019, the OECD released the Stage 2 peer review report for the United States relating to the BEPS minimum standard under Action 14 on improving tax dispute resolution mechanisms.

The US was among the six assessed jurisdictions included in the first batch for which the OECD has released Stage 2 peer review reports. (The other Stage 2 peer review reports covered Belgium, Canada, Netherlands, Switzerland, and the United Kingdom.) Overall, the report concludes that the US addressed most of the shortcomings identified in its Stage 1 peer review report. The report noted that although US tax treaties contain a provision relating to mutual agreement procedures, not all US treaties are consistent with the requirements of the Action 14 minimum standard.

In addition to the peer review report, the OECD released an accompanying document addressing the implementation of best practices.

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