

## **26<sup>th</sup> Annual TEI-SJSU High Technology Tax Institute**

*Sponsored by*

Tax Executives Institute, Inc

&

San José State University

College of Business

*Summaries written by SJSU MST Students*

### **Introduction**

**By Ankit Mathur**

The Annual High Technology Tax Institute has always been an event of epic proportions. Since 1984, the Santa Clara Valley Chapter of Tax Executives Institute and San José State University's College of Business have sponsored this gathering of some of the most prominent tax professionals in the Silicon Valley and beyond to discuss current and upcoming tax issues relevant to high technology industries.

As usual, the 2010 Institute was led by a panel of nationally and internationally renowned tax practitioners and government representatives. Several SJSU MST students had the opportunity to attend to both learn and report on a presentation for the *SJSU MST Contemporary Tax Journal*.

This year's prominent speakers included Eric Solomon and Heather Maloy. Mr. Solomon was the former Assistant Secretary for Tax Policy in the U.S Treasury Department, now with Ernst & Young. Heather Maloy is the Commissioner of the Large Business and International Division of the IRS.

From the IRS proactively trying to build better relationships with their customers to the humorous exchange by panelists Jeff Sokol and Glen Kohl, the 2010 Institute was

a memorable event and a commendable effort by SJSU and TEI.



We hope the summaries that follow provide not only a tax update but a glimpse of the Institute and we encourage our readers to attend the 27<sup>th</sup> Annual High Technology Tax Institute, scheduled for November 7 and 8, 2011 (<http://www.tax-institute.com>).

In this special report, you'll find summaries prepared by MST students of the following presentations:

1. International High Technology U.S. Tax Current Developments presented by Jim Fuller, partner at Fenwick & West

2. International and Multistate Concepts presented by Morgan Lewis tax partners Bart Bassett and Kim Reeder.
3. Getting Proper Research Credit presented by Grant Thornton partner Mark Andrus, PWC partner Jeffery Jones and Internal Revenue Service representative Roger Kave.
4. Cross Border Issues presented by Grant Thornton principal David Bowen, IRS representative Steven A. Musher and Fenwick & West partner Ron Schrottenboer.
5. M&A Hot Topics presented by Ernst & Young partner and SJSU MST faculty Danni Dunn, Wilson Sonsini Goodrich & Rosati partner Ivan Humphreys and Latham partner Kirt Switzer.
6. Successful Tax Practice in China and India, presented by KPMG senior manager Ajay Agarwal, Deloitte managing director Lili Zhang, and Baker & McKenzie partner Jon Eichelberger.

## **International High Technology U.S Current Tax Developments**

### **The Tale of Two Foreign Tax Credits**

**By Ankit Mathur**

James P. Fuller, partner at Fenwick & West, commenced the first morning of the Tax Institute with his presentation on the latest international tax developments. Mr. Fuller, a regular presenter at this conference, referenced his trademark 100+ page presentation throughout, covering such topics as subpart F income, foreign tax credits, and tax treaties.

As much as I want to cover his entire presentation, I will cover foreign tax credits since Mr. Fuller described a very interesting tale that I want to share. It is a tale of denial and lack of foresight; a tale about how Proctor & Gamble was allowed to claim foreign tax credits for taxes withheld in Korea, but was denied a previously claimed credit on Japanese taxes.

Proctor & Gamble's subsidiary in Singapore has its head office in Japan from where it oversees operations in Japan and Korea. Its Singapore operations did not have an office or employees in Korea but contracted with

local manufacturers to produce the products and then sold them in the Korean marketplace. The products were already subjected to Japanese taxes on royalty payments, and in 2006 Korean auditors came knocking on the door for their share of royalty payments made on sales in the Korean market. The Koreans attributed the payments as made to Korean sourced income from sales in their marketplace. P&G's Korean counsel provided a written memorandum advising against invoking treaties or challenging the assessment as it would be futile and since the tax assessment was correct, P&G obliged with the taxes.

Now we are back in the U.S where it's time to file the returns and P&G justly files for the credits on its foreign sourced income under Section 901(a).

The IRS initially denied the taxes paid to the Korean authorities because they felt that P&G did not exhaust all of its remedies available to them as they should have under

Reg. Section 1.901-2(e)(5). The IRS did not accept the written memorandum provided by the Korean Counsel, but the court decided that it was sufficient proof to show that P&G met the requirements under Reg. Section 1.901-2(e)(5). So this aspect of the case was held in favor of P&G and the multinational corporation trades happily ever after. Or does it!

The court did allow claims to foreign tax credits for Korean taxes, but reduced it by the credits claimed for Japanese taxes because P&G did not exhaust their remedies in Japan under Treas. Reg. Section 1.901-2(e)(5). Neither P&G nor its Singapore subsidiary thought of seeking advice from a Japanese competent authority, nor did they challenge or seek a redetermination of the source of royalty income under Japanese law. The court stated, they had no problems with a corporation claiming credits for taxes paid to more than one country on a single stream of income, but the corporation had to first exhaust all of its remedies to reducing foreign taxes. If this rule did not exist, the U.S. Treasury would be forced to foot the bill for such taxes even if they were not properly imposed.

While Japan and Korea may uphold their claims on the same source of income, the court held that it is P&G's responsibility to exhaust all its remedies just as it did by obtaining the memo from the Korean Counsel.

In the end, the IRS did get their way. P&G's lack of foresight lost them their rights to the credits for Japanese taxes even though they were contesting the denial of credits on Korean taxes.

So, the moral of this story is that if you're claiming credits that have caveats such as Reg. §1.901-2(e)(5,) then you need to think of all possibilities and cover all the bases.

The case citation is *The Proctor and Gamble Company Subs. v. U.S.* Case No. 1:108-cv-00608 (DC OH, July 2010).

Now for some other international updates by Mr. Fuller:

*Affirmation of the Xilinx case:* Xilinx, a manufacturer of integrated circuits was denied the deduction of stock compensation under Section 83(h) by the IRS, who claimed the cost should be shared between Xilinx and its Irish subsidiary. The court found in favor of Xilinx stating that the two provisions at Reg. Section 1.482-1(b)(1) and Reg. Section 1.482-7(d)(1) create ambiguity for determining which costs must be shared and that there are many other factors in play, such as the treaty between U.S. and Ireland. The consenting judges found that Xilinx's understanding of the regulations was more widely shared in the business community. The IRS has issued an Action on Decision (AOD) for this case noting acquiescence in result only.

*US-Italy Treaty:* Speaking of treaties, U.S & Italy finally agreed upon an income tax treaty and the announcement was made by the Treasury in 2009. It took a mere ten years for this treaty to come into force, but hopefully it will not take another 10 years to make updates to the provision that have become outdated in the last decade. A few other countries that signed a treaty with the U.S. include Malta, Hungary and Chile.

While this summary does not do justice to Mr. Fuller's complete, in-depth presentation, I hope it provides a glimpse of the presentation, and refreshed the memories of those who did attend the event. Mr. Fuller's coverage of the vast array of topics goes to show the numerous opportunities in international taxation and the scope of planning and creativity needed to be successful in this field.

## **International and Multistate Concepts Similarities, Differences and Traps**

By Zhihua Cai

Which standards determine the jurisdiction that has the authority to impose tax on inbound taxpayers? Does the state conform to the Federal rule about the net operating loss utilization and anti-inversion rules in international restructurings? How does the State report the subpart F income of a controlled-foreign corporation in Water's Edge combined reporting? What is the state trend in application of transfer pricing issues?

These were the questions discussed by Bart Bassett and Kim Reeder, tax partners at Morgan Lewis, at the 2010 High Tech Tax Institute.

### **Which jurisdiction should tax?**

Per Mr. Bassett, from a U.S. Federal standard, the concept of "permanent establishment" is used to determine whether inbound taxpayers should be taxed within a particular jurisdiction. Permanent establishment is constituted if taxpayers are engaged in a U.S. trade or business, and taxation of income is effectively connected with such U.S. trade or business. The definition of permanent establishment typically excludes certain fixed operations, such as the storage of goods or merchandise, or other activities that are preparatory and auxiliary in nature. Further, the standard of permanent establishment is always subjected to the override by U.S. tax treaties. Mr. Bassett emphasized, that the U.S. treaties are only binding on Federal standards, and not applicable to the State's. From a State standard, Ms. Reeder mentioned the concept of "nexus" is used to determine whether inbound taxpayers are subject to tax in a specific State. Nexus exists when the taxpayer is doing business in a state. The nexus principle is also subject to the U.S.

Commerce Clause, which requires the taxpayer to have substantial nexus within a state. States may also apply different standards in the income/franchise and sales/use tax contexts. For example, if the U.S. contract manufacturer is engaged to process goods consigned by a foreign taxpayer, it may not form a permanent establishment; however, it may meet nexus standard if it is doing business in this state.

### **Federal conformity**

Net operating losses ("NOLs") from a federal standpoint are subjected to many limitations one of them being Section 382. Each state does not fully conform to the federal standard and has its own rule to limit the net operating loss utilization. For example, CA and some other states have limited the utilization of NOL's because of the budget crisis. The NOL deduction in CA has been suspended for all tax years beginning on or after January 1, 2008 and before January 1, 2012. Carry forward period is also extended. In international restructurings, States do not conform to the federal rule in the application of Section 7874 anti-inversion rule. For example, if a foreign company is restructured as a holding company for the groups, from a federal standpoint, assuming the group does not have "substantial business activities" in the corporation, the anti-inversion provision of Section 7874 causes the foreign corporation to be characterized as a U.S. corporation for all U.S. federal income tax purposes. Thus, Section 367 is not applicable. The transaction is a U.S.-to-U.S. reorganization or a Section 351 transaction. From California's standpoint, it does not follow Section 7874 anti-inversion provision, thus the U.S. characterization of the foreign

company is not applicable. Section 367 (a) causes the transaction to be taxable at the shareholder level- triggering any gains (not loss) realized by the U.S. shareholders pursuant to Treas. Reg. Section 1.367 (a)-3.

#### **Water's edge reporting issues for CFCs**

Ms. Reeder said the Water's edge reporting for CFCs is always complicated. For the water's-edge combined reporting, existing law requires including the "Subpart F" income of a CFC to the extent of the inclusion ratio, regardless of whether the foreign corporation is a California taxpayer. IRC Section 957. Calculating the inclusion ratio involves multiplying the CFC's net income by a ratio of its subpart F income for the taxable year to its earnings and profits for the taxable year. A taxpayer may exclude Subpart F income from the inclusion ratio if it qualifies as high foreign tax income under Section 945(b)(4). Income will qualify as high foreign tax income if a taxpayer establishes that such income is subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax specified in Section 11.

#### **Transfer Pricing – State and local tax trend**

Mr. Bassett described that states have begun to use Section 482-like the power to redistribute income among related entities recently. Currently most states incorporate an arm's-length standard consistent with Section 482 or adopt a language that is broader than Section 482 to solve transfer-pricing issues. *Comptroller of the Treasury v. Gannett Co., Inc.*, 741 A2d 1130 (1999). Cal. Rev. & Tax. Code Sec. 25104. N.C. Gen. Stat. Sec. 105-130.6. For audit purposes, Section 482 applies to the previous years although those rules are changed for tax years beginning in or after 2007.

The international and multistate concepts are intersected with each other. In some tax issues, states start getting closer to the federal rules, such as the transfer pricing principle. However, in others, states do not conform to the federal rule due to the specific reasons. Having a clearer picture of the similarities, differences & traps among the international and multistate concepts will help provide better tax planning advice.



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## Getting Proper Research Credit

By Tim Kelly

A well-attended concurrent session covered “Getting Proper Research Credit,” with Mark Andrus of Grant Thornton, Jeffrey Jones of PwC and Roger Kave from the Internal Revenue Service. Given the fact that the research tax credit lapsed at the end of 2009 you might ask yourself why this session was even included in this year’s event?

Historically, countries have enacted barriers to prevent foreign investment in domestic businesses. As trade barriers fell and the developed countries became more integrated, U.S. policymakers have walked a tight rope balancing policy designed to keep jobs and capital at home while attracting foreign investment. One such policy enacted in the early 1980s was the research and development (R&D) tax credit. In simplistic terms, a taxpayer’s expenditures to develop and improve new and existing products can be used to generate an R&D tax credit to offset federal income tax. The “cost” of the credit<sup>1</sup> and the focus on enacting revenue neutral legislation has caused Congress to never make the R&D tax credit permanent. Since 1981, the credit has lapsed several times and been temporarily renewed at least a dozen times. Over the past 30 years, the value of the credit has diminished relative to other countries. Studies have placed the United States anywhere from 17<sup>th</sup> to 24<sup>th</sup> in a ranking of nations that have incentives to promote research and development expenditures.<sup>2</sup> As

a result, more and more U.S. corporations have been conducting a greater percentage of their research and development in foreign countries to take advantage of the more lucrative incentives offered by those countries.

Given the history and economic importance given to the R&D credit, it’s expected to be renewed by the end of 2010. The panel indicated there was strong bipartisan support and that President Obama had proposed making the credit permanent to eliminate uncertainty as well as to increase the alternative simplified research credit rate from 14% to 17%<sup>3</sup>. There was no discussion on broadening the variety of R&D expenditures that currently do not qualify, such as in-process R&D.

The majority of the panel discussion focused on the friction between



taxpayers and the IRS when a research credit claim is denied based on a lack of “proper” documentation and the linking of a new or improved “business component” to the qualified research expenditures.

*I can’t define it, but I know research and development when I see it:* How do taxpayers properly document R&D and link it to an R&D activity to claim proper credit and survive a subsequent examination by the

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<sup>1</sup> Per the Joint Committee on Taxation (JCS-1-10), the “cost” of the credit is about \$5 billion per year; <http://www.jct.gov/publications.html?func=startdown&id=3642>.

<sup>2</sup> ITIF, 11/20/10; <http://www.itif.org/files/ExpandR&D.pdf>, 11/20/2010, and Deloitte (2/10); <http://www.investinamericafuture.org/PDFs/2009>

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[Global%20SurveyRandDTaxIncentivesDeloitteFebruary2010.pdf](http://www.deloitte.com/Global%20SurveyRandDTaxIncentivesDeloitteFebruary2010.pdf).

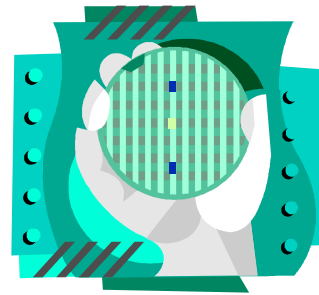
<sup>3</sup> Tax extenders bill introduced by Baucus (D-MT) on Sept. 16, 2010 to extend R&D credit to 12/31/10. White House research credit proposal, 9/8/2010; [http://www.whitehouse.gov/sites/default/files/fact\\_sheet\\_re-credit\\_9-8-10.pdf](http://www.whitehouse.gov/sites/default/files/fact_sheet_re-credit_9-8-10.pdf).

Service? Taxpayers have relied on their financial records and documentation to substantiate their R&D credit claim, while the IRS has targeted use of estimates in determining qualified research expenses (QREs) and gross receipts to disallow the claim for credit. Examining agents prefer a project accounting approach rather than the more common cost center approach used by a majority of taxpayers. It was suggested that IRS field agents have been inconsistent and failed to take direction from the IRS National Office and the Research Credit Audit Guidelines, which allow for the cost center method to computer a taxpayer's R&D credit. The panel outlined a series of cases<sup>4</sup> that have held in favor of the taxpayer with regard to the use of estimates and employee testimony as a basis for substantiating R&D credit claims.

Next, the panel offered guidance on how to prepare and survive an examination. A few key points that seem obvious are worth mentioning. Taxpayers should know their data, documentation and methodologies ahead of the audit. Employees involved in R&D activities should be aware of the requirements to be effective in an interview. Prepare a road map for the exam team and address the important issues in the beginning. Most importantly, keep communication open from the start and continue to ask if there are any issues. In other words, don't wait until the end of the audit to find out that the exam team has a problem with your documentation.

With time running out the panel quickly reviewed a few other topics including issues regarding controlled foreign corporations in calculating gross receipts<sup>5</sup>, qualified

supplies expenditures<sup>6</sup> and standards for internal use software<sup>7</sup>.



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<sup>4</sup> *McFerrin*, No. 08-20377 (5th Cir. 6/9/09), *TG Missouri Corp. v. Comm'r*, 133 T.C. No. 13 (2009), *Trinity Industries, Inc. v. United States*, 691 F. Supp. 2d 688 (N.D. Tex. 2010).

<sup>5</sup> *Proctor and Gamble v US* (S.D. Ohio, 2010) held P&G may disregard inter-company transactions

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with foreign controlled group members in computing its research credit.

<sup>6</sup> *Trinity Industries v U.S.* (N.D. Tex. 2010) held for taxpayer, depreciable property should be evaluated in the hands of the taxpayer to determine if is subject to the allowance for depreciation.

<sup>7</sup> *FedEx v. U.S.*, (W.D. Tenn. 2009) Taxpayer can rely on withdrawn 2001 regulation IUS high threshold of innovation standard, "The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant.

## **Cross Border Issues**

**By Marja Mirkovic**

The presentation on cross-border or transfer pricing issues covered new legislative proposals concerning intangibles, the future of Section 482 guidance, transfers of intangibles and cost sharing agreements. The presentation was led by David Bowen and Laura Clauser with Grant Thornton, IRS Associate Chief Counsel Steven A. Musher, and Fenwick & West partner, Ron Schrottenboer.

### **Summing up Transfer Pricing**

Transfer pricing is an area of tax compliance that has gained substantial importance and scrutiny. As of January 2009, 48 countries enacted legislation with respect to transfer pricing, as compared to five countries in 1997. Transfer pricing issues are relevant to multinational corporations that have foreign subsidiaries. The purpose of transfer pricing regulations is to ensure that the right amount of taxes are paid in the right location by properly allocating profits and costs between the U.S. parent company and its foreign subsidiaries.

Transfer pricing is the price at which goods, services and intellectual property are transferred between related parties of a multinational business across international borders. Market forces do not set prices between related parties, so related parties could be overcharging or undercharging for particular goods and services. Tax authorities are concerned that this could allow companies to shift taxable profits to different jurisdictions, this concern led to the transfer pricing regulations and enforcement activities.

### **The Disputed Art of Valuing Intangibles**

Intangible assets are gaining more attention from the IRS and the Organization of Economic Cooperation and Development

(OECD) as intercompany transactions of intangible property are becoming one of the most common causes of tax disputes.

Unlike tangible assets, multiple users can employ intangible property simultaneously without diminishing its usefulness. With the global growth of the technology industry the number of intangibles are rising and being a valuable asset, it demands new rules in identifying, determining and valuing them.

Treas. Reg. Section 1.482-4(b) defines intangibles as including patents, formulae, patterns, processes, expertise, copyrights, trademarks, licenses, systems, procedures, forecasts, customer lists, etc. Currently there is a debate on whether goodwill, workforce and going concern value should be included as intangibles per Treas. Reg. Section 1.482-4(b).

Another issue that was discussed was the difference in valuation of acquired intangibles. The main difference in valuation methods stem from differences in assumptions about the useful life of acquired intangibles. Under the acquisition price method, it is assumed that the useful life of intangibles is perpetual, while under the income method the useful life is six years. A new set of rules is needed to accurately determine the useful life of intangibles. In addition, we need to indentify the facts that are relevant for that determination.

These are only some of the issues concerning valuation and cost sharing methods related to profits from intangibles. We should look out for new sets of guidance and regulation concerning these issues in the near future. This presentation stressed the need for awareness on increasingly significant transfer pricing issues and the need for new regulations concerning intangibles.



## Mergers & Acquisition Developments

By Zhihua Cai

The M&A panel addressed current developments in the area including transaction trends. In addition, in its discussion, the panel touched upon the history of rescission doctrine and relevant private rulings, the application of Section 382 poison pills and charter amendments, and other issues.

Ivan H. Humphreys, partner at Wilson Sonsini Goodrich & Rosati, illustrated that M&A activity has increased roughly 10% in the high-tech sector over 2009. Among these transactions, large public ones have dominated the landscape. For most large-scale public transactions, tax participation is usually fairly limited, and key tax participation occurs in the post-deal integration. For example, deal terms in a public transaction usually do not include tax indemnity agreements, and tax representations made by targets thus serve a diligence and information gathering function. However, Mr. Humphreys noted, compared with the large public transactions, the “mid-market” deals, i.e. the transactions involving the acquisition of private companies under \$500 million, have more tax participations in the transaction itself.

Traditionally, acquisitions of venture capital backed private companies did not contain a “pre-closing tax” indemnity. However, currently, separate pre-closing tax indemnity is becoming more prevalent. Mr. Humphreys also mentioned other special deal terms in the private M&A transactions that are different from public transactions.

Danni Dunn, partner at Ernest & Young, LLP, introduced the rescission doctrine that has applied in the corporate mergers and acquisitions context. The doctrine was first established in the landmark case of *Penn v.*

*Robertson*, which allowed taxpayers who had completed a transaction, an opportunity to unwind it, and to treat the transaction as if it had never



occurred. The Internal Revenue Service later acknowledged this principle in Rev. Rul. 80-58. Ms. Dunn said that for the rescission doctrine to apply: 1) the parties to the transaction must be restored to the same position they would have occupied had no contract been entered into (the “status quo ante” requirement); and 2) the rescission must occur in the same tax year of each party in which the original transaction took place (the “same taxable year” requirement). Rescission may be effected in the following ways: by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other (only if sufficient grounds exist), or pursuant to a court order. Ms. Dunn noted that business purpose is not required for the introduction of the rescission doctrine, and a tax reason is sufficient for taxpayers to unwind a transaction per the rescission doctrine. Ms. Dunn explained several private letter rulings issued by the IRS in recent years that address the application of the rescission doctrine to particular situations and provides additional guidance to taxpayers who have entered into transaction that they now wish to unwind. However, Ms. Dunn noted that the previous situations addressed by the IRS are all private rulings, instead of revenue rulings. So, taxpayers should be cautious to rely on

these private rulings. Seeking a tax advisor's opinion or perhaps requesting a private letter ruling is strongly recommended for specific issues.

Kirt Switzer, partner at Latham & Watkins, LLP, discussed the background and mechanics of Section 382 poison pills that limit risk of ownership changes if significant net operating losses ("NOLs") are at involved. NOLs can be used to offset a company's future income tax liability when and if a company has taxable income. Under Section 382, changes in ownership can effectively cap the amount of a target's NOL that an acquirer can use to offset its future tax liability if a shareholder owing 5% or more of the company increases its ownership by more than 50% of its lowest level of ownership during the last three years. Mr. Switzer said that public companies may seek to take action, such as charter amendments in bankruptcy proceedings, adopting Section 382 poison pill plans, or charter amendments requiring

shareholder approval. Among them, Mr. Switzer mentioned, an application of Section 382 poison pill was upheld by Delaware Chancery Court in *Selectica, Inc. v. Versata Enterprises*, which was finally confirmed by Delaware Supreme Court. Traditionally, the poison pill plans are intended to thwart a hostile takeover, and it is triggered when the stock ownership reaches the threshold of 10-20%. Different from a traditional poison pill, a Section 382 poison pill is designed to protect a company against loss of the use of NOL carryforwards, and the trigger shareholder is around 5%. In that case, the company may trigger shareholder rights to purchase stock at a deep discount to dilute 5% (or potentially 5%) shareholders. However, Mr. Switzer also pointed out that Section 382 poison pills have their limitations because NOL poison pills can't prevent an ownership change and it may potentially create a new 5% shareholder

## **Indian Direct Tax Code**

### **Changing Horizons for Foreign Investments**

**By Sampada Deshmukh**

India and China are emerging as the two leading powerhouses in the world. These are vast countries filled with opportunities and risks for investors. Both countries have shown their strength during the period of recession with a GDP growth rate of 7.2% (India) and 10.2% (China) in 2008<sup>8</sup> when other countries barely managed to have a positive growth rate.

The High Tech Tax Institute presented an excellent opportunity for tax professionals and students to learn more about the recent developments in the tax regime of India and China. Lili Zheng, Co-leader of Deloitte's Asia Pacific International Core of Excellence based in Hong Kong, started the presentation with a discussion of the importance of India and China today and in the future. Jon Eichelberger, partner with Baker & Mackenzie, provided insightful information regarding recent tax developments in China and also stressed some critical issues for foreign companies looking to establishing and expanding their

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<sup>8</sup> International Monetary Fund, Initials. (December 2009). *Rebalancing growth in asia*. Retrieved from <http://www.imf.org/external/pubs/ft/fandd/2009/12/prasad.htm>.

businesses in this country. Ajay Agarwal from KPMG focused on the Indian Direct Tax Code and its impact on foreign businesses in India. This article focuses on opportunities and risks faced by foreign companies while investing in India, as covered by Mr. Agarwal.

India, one of the fastest growing free market economies, presents extended opportunities for all types of investments to foreign companies, foreign institutional investors (FIIs) and non-resident Indians (NRIs). The Indian market, with its one billion plus population, and 8.4%<sup>1</sup> growth rate presents lucrative and diverse opportunities for companies with the right products, services and commitment. With a sustained projected growth rate of 8-10% for the next few years, the Indian economy seems promising and attractive for many foreign companies. However, the constant changing of exchange control and tax regulations require foreign companies to effectively plan their strategies for establishing new or expanding their existing business in India.

### **Direct Tax Code Bill (DTC) 2010**

The Indian government has taken significant steps for simplification of tax laws by enacting the Direct Tax Code (DTC). The DTC replaces the current Income Tax Act of 1961 (ITA) and comes into effect starting April 1, 2012. The DTC is considered a necessary and effective step for bringing Indian regulations in line with the global economies. Foreign companies however, need to consider the effects of these revised regulations on their existing or new businesses.

The DTC rules aim at bringing the definition of residency in line with international practice. The company incorporated outside India would be resident in India, if its “place of effective management” at any time in the year is India. The place of effective management of company means: A place

where board of directors or executive directors make their decisions. In situations where the board of directors routinely approve the commercial or strategic decisions made by executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions.

### **General Anti Avoidance Rules (GAAR)**

The DTR also aims at regulating abuse of tax rules by introducing General Anti-Avoidance Rules (GAAR) in the Indian Tax regime. GAAR provisions empower the tax authorities to declare an arrangement as impermissible if it has been entered into with the objective of obtaining tax benefits. GAAR is not invoked for every transaction involving tax mitigation. An impermissible arrangement is one, which has tax benefit as the main purpose and satisfies any one of the basic conditions. Private equity funds set up abroad and making investments in India through intermediary holding companies like Mauritius, Cyprus, etc., are likely to come under the preview of GAAR.

### **Controlled foreign Corporation (CFC) Rules**

The CFC rules were introduced as an anti-avoidance measure to prevent tax deferrals and tax avoidance by domestic residents including companies looking to establish foreign entities in low tax jurisdiction and diverting income to such entities. The CFC rules focus on an entity approach rather than income, although income is an important factor as to whether or not CFC rules apply. These rules apply to passive income earned, but not distributed by a foreign company “controlled” directly or indirectly by one or more residents in India. Such income would be treated as deemed distributed and would be taxable in the hands of resident shareholders as dividends received from a foreign company. For this purpose, control means 50% or more control over voting

power or capital or a combination thereof of substantial interest /influence or control over income or assets of the CFC. CFC provisions do not apply if tax paid by a foreign company in its country of residence is less than 50% of the tax it would have paid in India as a domestic company as per the DTC in 2010. An exemption is also available if the CFC is listed on the stock exchange or its income does not exceed INR 2.5 million.

### **Transfer Pricing Provisions**

The DTC rules for transfer pricing are in line with the existing rules as per Income Tax Act, 1961. However, the definitions of “Advanced Pricing Arrangements (APAs)” and “Associated Enterprises (AE)” have been revised.

### **Associated Enterprises (AE)**

An international transaction means transaction between two AEs, either or both of which are non-residents. The definition of AE has been expanded to include a provision for services by one enterprise to another, directly or indirectly, where the conditions are influenced by such other enterprise. It is also required that any one of the enterprise that is part of the transaction be situated in any specific or distinct location as may be specified.<sup>9</sup>

### **Advanced Pricing Arrangements (APAs)**

APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. methods, comparables and adjustments thereto, critical assumptions as to future events) for determining the transfer pricing for those transactions, over a fixed period of time,

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<sup>9</sup> Tax Guru, Initials. (September 19, 2010). *General anti-avoidance rule (gaar), controlled foreign company (cfc) rules and amendment in transfer pricing (tp) provis.* Retrieved from <http://taxguru.in/articles/display/29/General%20Anti-Avoidance%20Rul/>.

which in this case is a maximum of five years. The DTC 2010 broadly provides mechanisms for entering into APA:

- The Central Board of direct Taxes (CBDT) , with the approval of Government of India, may enter into an APA with any person, specifying the manner in which arm’s length price (ALP) can be determined in relation to an international transaction.
- The ALP in an APA can be determined by using any method prescribed in the transfer pricing provisions, with such other adjustments as may be necessary or expedient to do so. This ALP shall be binding on both taxpayer and tax authority.
- The APA is valid for period specified in it subject to a maximum of five consecutive financial years.

### **Transfer of Assets by non-residents**

**Provisions:** A non-resident is liable to be taxed in India only on its income having a “source” in India. The concept of source covers income accruing or arising, or incomes deemed to accrue or arise in India or incomes received in India. Under DTC, the deeming income provisions have been expanded to include:

- Income from direct or indirect transfer of capital assets situated in India and
- Income from interest on debt used for earning any income from any source in India

The introduction of the DTC has been considered a noteworthy step to reduce complexity and bring clarity and precision to Indian tax laws. The Codification of GAAR and introduction of CFC rules shows new approaches of the Indian government to deal with tax avoidance. With India’s growing

importance in the global market it is essential for the foreign companies directing investments and expansion in India to

familiarize themselves with the tax rules and assess the impact of these rules on their businesses.

## Federal Domestic and State Tax Updates

By Ami Shah

Uncertainty is the only word that describes this year's position on tax laws. There might be several changes from the Institute date until year end, but this article describes a few of the changes made before December 2010 and summarizes the presentation "Federal Domestic and State Tax Updates" made at the 2010 High Technology Institute by Annette Nellen, Director of the San José State University MST program, and Tony Fuller, Managing Director with Alvarez & Marsal Taxand, LLC.

Several bills were passed in 2010. The Hiring Incentives to Restore Employment (HIRE) Act, Patient Protection and Affordable Care Act and Small Business Jobs Act are just a few examples that made significant impact on the federal tax system.

Here is a summary of some of the new provisions.

### Section 179 expensing

For 2010 and 2011, the expensing amount under Section 179 is \$500,000 with the phase-out starting at \$2 million. New law increases the qualifying property cap from \$800,000 to \$2 million, which effectively increases the availability of Section 179 expensing to many more businesses. Under the new law, the Section 179 expensing deduction does not phase out completely until the cost of eligible property exceeds \$2.5 million. Taxpayers may also expense up to \$250,000 of the \$500,000 for qualified real property.

### Bonus Depreciation

New law extended 50-percent first-year bonus through December 31, 2010 (it had expired at the end of 2009). Extension is retroactive to January 1, 2010.

New law also extends, through 2011, the additional year of bonus depreciation allowed for property with a recovery period of 10 years or longer, and for transportation property (tangible personal property used to transport people or property). Bonus depreciation is not limited by the size of the business, unlike practical access to the Section 179 "small business" expensing. Bonus depreciation is by far the most expensive single tax break in the bill, weighing in at \$5.4 billion over 10 years, but carrying an initial cost of \$29.5 billion in its first two years because of accelerated depreciation that would otherwise be deducted in later years.

### Small Business Stock

The American Recovery and Reinvestment Act temporarily increased the Section 1202 percentage exclusion for qualified small business stock issued to a non-corporate investor from 50 percent to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011, and held for more than five years. New law raises the



exclusion to 100 percent for gain on stock acquired after September 27, 2010 and before January 1, 2011. Under the new law, the excluded gain will not count as an AMT preference item, but the five-year holding period continues to apply.

### **S Corporation Built-in-Gain**

For tax years beginning in 2011, the S corporation built-in gain recognition period is 5 years, thus making it easier to avoid the built-in gains tax. So, there is no built-in gains tax on net recognized built-in gain of a S corporation for the tax year beginning in 2011 until the 5th year in the recognition period (since converting from C to S) preceded that tax year.

### **General Business Credit Carry back**

New law extends the carryback period for eligible small business credits to five years. Eligible small business credits are the sum of the general business credits, such as the research credit, determined for the tax year with respect to an eligible small business. The extended carryback provision is effective for credits determined in the taxpayer's first tax year beginning after December 31, 2009.

### **Health Insurance Deduction for Self-Employed**

Usually a self-employed individual can take deductions for health insurance costs paid for the individual and his or her immediate family for income tax purposes. However, in

determining the self-employment income subject to self-employment taxes, the self-employed individual cannot deduct any health insurance costs. Under the new law, the deduction for income tax purposes for the cost of health insurance is allowed in calculating net earnings from self-employment for purposes of self-employment taxes. The provision only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009.

### **Removal of Cellular Telephones from Listed Property**

New law removes cell phones and similar personal communication devices from their current classification as listed property under Section 280F, thereby lifting the strict substantiation requirements of use and the additional limits placed on depreciation deductions.

### **More Changes to Come**

Tax cuts signed by President George W. Bush in 2001 and 2003 are due to expire at December 31, 2010. President Obama wants them extended only for couples earning up to \$250,000 (singles up to \$200,000), saying the cost to extend them for the wealthiest Americans is too high. Republicans want them extended for everyone, so that no one's taxes rise while the economic recovery is weak. At November 8, 2010, Congress had not finalized many issues at hand, but the panelists noted that additional legislation was expected before year end.

