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In this issue:

Unforeseen Difficulties to Analyzing US Income Tax Treaties through the Derivative Benefits Provision

US income tax treaties can often times be compared to snowflakes. While all of them are quite similar in structure and purpose, no two are exactly alike. This is especially true when evaluating the limitation on benefits ("LOB") article in modern US treaties and the strict language of many recent derivative benefits provisions, which may surprise those unfamiliar with these limitations.

Many of us are all too familiar with the intent and scope of the modern LOB article but what some may not initially focus on is the extent to which a foreign corporation satisfies or fails one or more of the LOB provisions can vary greatly from treaty to treaty. This is particularly true of the derivative benefits provision. In general, under a specific income tax treaty, the derivative benefits test is designed to treat certain subsidiaries of an entity or group of owners, which themselves are treated as qualified residents under a separately applicable income tax treaty with the U.S, as a qualified resident.

For instance, assume ForCo 1, a corporation resident and publicly traded in the United Kingdom ("UK"), qualifies for benefits under the US-UK income tax treaty (the "UK Treaty") (because it is publicly traded and meets all of the requirements of Article 23(2)(c)(i)), owns 100 percent of ForCo 2, a group financing subsidiary resident in Belgium. It would be a reasonable assumption that ForCo 2 should also be entitled to benefits under the US-Belgium income tax treaty (the “Belgian Treaty”). However, such reasoning actually may prove to be inaccurate under the derivative benefits clause of the Belgian Treaty.

The actual language of Article 21(3) of the Belgian Treaty provides that a company that is a resident of a Contracting State is entitled to the benefits of the Belgian Treaty if it meets a two pronged test. First, at least 95 percent of the aggregate voting power and value of the company’s shares must be owned by seven or fewer equivalent beneficiaries. Second, less than 50 percent of the company’s gross income for the taxable year can be paid or accrued to persons who are not equivalent beneficiaries in the form of payments that are tax-deductible in the company’s State of residence (excluding arm’s length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to an unrelated bank).

The first key determination that must be made in analyzing this article is understanding the meaning of the term “equivalent beneficiary”. Article 21(8)(g) states in part that the term “equivalent beneficiary” means a resident of a member state of the European Union, any other European Economic Area state, a party to the North American Free Trade Agreement, or Switzerland which would be entitled to all the benefits of a tax treaty between any member state of the European Union or any other European Economic Area state, any party to the North American Free Trade Agreement, or Switzerland, and the State from which the benefits of the Belgian Treaty are claimed under provisions analogous to Article 21(2)(a), (b), (c)(i), or (d). If such tax treaty does not contain a comprehensive limitation on benefits provision, Article 21(8)(g) requires that the “equivalent beneficiary” must be entitled to the benefits of the Belgian Treaty by reason of Article 21(2)(a), (b), (c)(i), or (d) if such person were a resident of one of the Contracting States under Article 4 (Resident).

The relevant subparagraphs Article 21(2) of the Belgian Treaty referenced in the equivalent beneficiary definition above provide that a resident of a Contracting State is entitled to all the benefits of the Belgian Treaty if the resident is either (a) an individual, (b) a Contracting State or political subdivision thereof, (c) a company, if certain conditions are satisfied, or (d) a person described in Article 4(3) if certain additional conditions are met[1]. A resident company may qualify for benefits under Article 21(2)(c)(i) if its principal class of shares is regularly traded on one or more recognized stock exchanges, and either (A) its principal class of shares is primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident (or, in the case of a company resident in Belgium, on a recognized stock exchange located within the European Union or in any other European Economic Area state, or, in the case of a company resident in the United States, on a recognized stock exchange located in another state that is a party to the North American Free Trade Agreement), or (B) the company’s primary place of management and control is in the Contracting State of which it is a resident. Thus, in essence, an “equivalent beneficiary” needs to be either an individual, a part of government, a publicly traded entity (not a subsidiary of a publicly traded entity, even if it is incorporated in the same country), or a pension fund or charitable organization.[2]

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[1] A pension fund or certain charitable or other organizations.

[2] Compare this article with that of the U.S.-Luxembourg income tax treaty (Article 24(4)(a)), which provides for a much more expansive derivative benefits provision to include entities that are “residents of a state that is a party to NAFTA or that is a member State of the European

In the case described above, ForCo 1 should meet the definition of an equivalent beneficiary because it is a publicly traded UK entity that satisfies Article 23(2)(c)(i) of the UK Treaty, which is comparable to Article 21(2)(c)(i) of the Belgian Treaty. Nevertheless, there is more to analyze in order for ForCo 2 to meet the requirements of the derivative benefits test, including whether ForCo 2 passes muster under the base erosion prong of the derivative benefits test under Article 21(3)(b).

In order for that to happen, ForCo 2 must not make payments to persons who are not equivalent beneficiaries that are deductible for Belgian tax purposes and which are equal to or in excess of 50 percent of ForCo 2's gross income for the taxable year. Although there is an exception for payments made for tangible property or services as well as for payments on financial obligations to unrelated banks[3], analyzing whether or not ForCo 2 meets this test requires an examination of all payments made by ForCo 2 that are deductible for Belgian tax purposes. Problematic issues can arise when ForCo 2 has borrowed from other group members that are not ForCo 1 (e.g., ForCo 3). This unfavorable result is because any other group member (other than ForCo 1) cannot meet the definition of an equivalent beneficiary under Article 21(8)(g), because any other group member would not be an individual, a part of government, a publicly traded entity, or a pension fund or charitable organization. In such case, if the tax-deductible interest on borrowings from ForCo 3 equals or exceeds 50 percent of ForCo 2's gross income, ForCo 2 would fail the base erosion prong of the test. Accordingly, ForCo 2 would not satisfy the derivative benefits provision, even if ForCo 3 would otherwise be a qualified resident under an income tax treaty with the US.[4]

Although ForCo 2 could satisfy the ownership prong of the derivative benefits test, it may fail to satisfy the test where it has borrowed to fund its lending operations from any related party other than ForCo 1. This restrictive result is perhaps counterintuitive to a holistic approach to the derivative benefits test and a corresponding assumption that because the ultimate European Union parent qualifies for benefits under a US income tax treaty, every other European Union group entity should also qualify. Accordingly, for those contemplating a restructuring of internal group financing with the US, especially in light of the recent BEPS proposals, a careful consideration of the derivative benefits provision should be a top priority.

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Union" and allows those residents to qualify for benefits under such income tax treaties in any manner possible.

[3] Note that depending upon the specific income tax treaty, an exception for certain payments, such as payments to a bank, may not be applicable (for instance, see Article 28(3) of the U.S.-Germany income tax treaty).

[4] Note that additional questions arise when the financing instrument is an equity instrument on which a notional deduction is applied for Belgian tax purposes, or an interest free loan upon which interest expense is imputed, but those are topics for another installment of Inbound Corner.

BEPS Action 13: Country-By-Country Reporting Implementation Package

On 8 June 2015, the OECD, as part of the G20/OECD work on the action plan to address base erosion and profit shifting (BEPS), released Action 13: *Country-by Country Reporting Implementation Package*. This follows the two reports previously issued by the OECD: (i) the agreement of a three-tier global standard for transfer pricing documentation, including a common template for county-by-country (CbC) information to be reported to the tax authorities (released in September 2014); and (ii) implementation guidance in relation to the CbC report, including the timing of introduction, application to "large" businesses and filing mechanisms (released in February 2015). The implementation package outlines model legislation that governments can use to adopt the new rules, as well as competent authority agreements to implement the sharing mechanisms for the CbC report.

Model legislation

The implementation package includes model legislation for countries to adopt CbC reporting in their domestic legislation.

Definitions: The model legislation includes some key definitions:

- **Group:** A collection of enterprises related through ownership or control that either is required to prepared consolidated financial reporting statements or would be so required if "equity interests in any of the enterprises" were publically traded on a stock exchange.
- **Excluded multinational enterprise group:** A group with consolidated group revenue of less than EUR 750 million at 1 January 2015 (or an equivalent in local currency). This will be tested against the results of the previous fiscal year. Such a group will be exempt from filing the CbC report.
- **Constituent entity:** Any separate business unit of the group, including companies together with permanent establishments that prepare separate financial statements for any purpose (including management control).

The model legislation sets out how to determine which constituent entity is required to file the CbC report (i.e. the "reporting entity"). This usually will be the "ultimate parent entity," as the company that prepares consolidated financial statements for the group. Where the ultimate parent entity either (i) is not required to file a CbC report in its jurisdiction; or (ii) has not signed up to the relevant information exchange agreements; or (iii) systematically has failed or suspended its agreement to exchange information, the group can appoint a "surrogate parent entity." This is a constituent entity within the group, in an appropriate jurisdiction with the ability to exchange information that is nominated to file the CbC report in its jurisdiction on behalf of the group.

If the CbC report is not, in certain circumstances, filed with and shared by the tax jurisdiction of either the actual parent company or a surrogate, companies may be required to file the CbC report locally. The model legislation allows a nominated constituent entity within a jurisdiction to file the report on behalf of all constituent entities in that jurisdiction.

Notification: Each constituent entity will need to notify its local tax authorities by the last day of the financial reporting year either (i) that it will be filing the CbC report for the group for the year, or (ii) the name and tax residence of the company that will file the report for that fiscal year.

Timing for preparation and filing of CbC reports: As previously announced, the G20/OECD proposes that CbC information should be required for years beginning on or after 1 January 2016 and should be filed annually within 12 months of the end of the financial reporting year to which it relates. Groups with a year ending 31 December 2016 will be the first to file, with a deadline of 31 December 2017. The contents of the CbC report will be as set out in the template issued in the OECD report from September 2014.

The model legislation does not include any specific penalty provisions for noncompliance. It leaves this for individual jurisdictions to determine in line with existing transfer pricing documentation penalties.

Competent authority agreements

The implementation package includes three model competent authority agreements that could be used by tax authorities to facilitate implementation of the exchange of CbC reports:

- **Multilateral competent authority agreement:** A multilateral agreement that allows jurisdictions to sign up and exchange information with all other appropriate jurisdictions signed up to the same agreement (based on the model used for the common reporting standard).
- **Tax treaty competent authority agreement:** To be agreed on a bilateral basis.
- **Tax information exchange agreement (TIEA) competent authority agreement:** To be agreed on a bilateral basis.

The three model agreements are worded similarly, including definitions that are consistent with the model legislation and include the scope, timing, procedures and safeguards applying to the automatic exchange.

Timing of exchange of information: Tax authorities will be required to share the CbC information with other relevant tax authorities within 18 months of the end of the financial reporting year for the first year, and within 15 months of the end of the financial reporting year for subsequent periods. For example, a group with a year ended 31 December 2016 will file its first CbC report by 31 December 2017, which then would be shared with other relevant tax authorities by 30 June 2018 (and then, for the year ended 31 December 2017, by 31 March 2019).

Confidentiality and safeguarding information: The exchange agreements make clear that information shared as a result of these agreements must be kept confidential and used appropriately. In particular, the agreements reiterate previous requirements that the information should not be used as a substitute for detailed transfer pricing analysis of individual transactions based on full functional and comparability analysis, and that transfer pricing adjustments should not be made on the basis of the CbC reporting alone. In addition, there are proposals to deal with tax authorities that breach confidentiality, or otherwise fail to comply with the terms, by excluding them from future information exchanges.

The implementation package also includes a questionnaire which outlines requirements for data safety and security for tax authorities to adhere to under normal international standards.

Comments

The implementation package is designed for governments to introduce the CbC report into their respective domestic legislation. In addition, it provides details of the exchange of information mechanisms by which tax authorities share the CbC report with their counterparts in countries where the multinational has a company or permanent establishment. The provision of model legislation (a first for the OECD in the area of international corporate taxation) is in clear support of the G20/OECD objective that the CbC report is to be a single international standard. As such, it is to be implemented consistently by all participating countries. Business will welcome such uniformity, which will be helpful in mitigating unnecessary compliance costs.

While the implementation package is clear that it is intended primarily for governments, there are a number of definitions that will be relevant to businesses. In particular, the model legislation sets out the meaning of group for the purposes of preparing the CbC report, basing the definition on groups required to prepare consolidated financial statements, or those that would have to if any of its enterprises were publically traded. There are no separate definitions in relation to the accounting rules for funds (that were specifically mentioned in the February 2015 implementation guidance as requiring further consideration).

Businesses that have a parent company in a country that does not adopt the CbC report, or does not share the report under the mechanisms proposed, will be helped by the option to elect a surrogate parent. Under this option, the group will have confidentiality protections for their information and will be required to prepare and file the CbC report only once, rather than locally in each country where they have operations.

The model legislation proposes an annual notification requirement such that all resident companies (including, presumably, dormant companies that are subject to the listing in the activities section on the second page of the report template) have to notify the tax authorities in their country of the identity and residence of their reporting entity, the group parent company or its elected surrogate.

The model legislation does not suggest a specific penalty regime in respect of the CbC report, but instead refers to extensions of existing country transfer pricing documentation penalty regimes to the requirements on the reporting entity to file the CbC report. This is appropriate in that the inference is that penalties for noncompliance should be restricted to the reporting entity rather than imposed on group companies with little or no control over the information provided.

As expected, the sharing of information will be by a suitable mechanism, either under existing tax treaties, TIEAs or under the OECD's mutual administrative assistance in tax matters convention (that has been signed by more than 80 countries to date). Businesses will be pleased to see specific safeguards relating to the confidentiality of data, and, as expected, restrictions on the use of the information to transfer pricing/BEPS risk assessment and economic analysis only.

The CbC report will need to be filed electronically in a tagged format. The OECD will release the xml tagging schema shortly and is currently looking at tax authority systems to enable the exchange of data in a secure, electronic, manner. The first exchanges are planned to take place six months after the due filing date for the first year (i.e. June 2018) and, in subsequent years, three months after the due filing date.

There is no further guidance on the master file and local file approach to transfer pricing documentation proposed alongside the CbC report. Businesses were disappointed in February that the master file was not to be subject to a parent-filing and government-sharing mechanism as for the CbC report, and therefore issues may remain in relation to enabling local filing of group information that is not in the possession of the local entity.

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US Sales and Use Tax: A survival guide for international business

Introduction

Companies based outside the US are sometimes surprised by the differences between US sales and use tax and international value added taxes. Both are indirect taxes with the similar purpose of taxing consumption, and both require attention and planning on the part of the seller, but there the resemblance ends. The task of identifying states in which sales and use tax compliance is required and how to apply each state's tax may seem daunting, but it's not impossible. This article discusses approaches and tools that businesses can use to proactively understand and take command of their US sales and use tax obligations.

Background

- Sales and use taxes are imposed on the sale of tangible personal property and certain enumerated services in 45 states and the District of Columbia.
- Generally, the place where possession or title passes to the customer determines which jurisdiction has the right to tax a sale of tangible personal property, while the place where the customer "receives the benefit" of a service determines which jurisdiction has the right to tax a service.
- When a sale made by a retailer is subject to sales tax, the retailer is generally required to collect the tax from the purchaser and report and remit that tax to the taxing authority.
- When an out-of-state retailer has not collected tax, a purchaser is generally required to report and remit applicable use tax directly to the taxing authority.
- When an out-of-state retailer makes sales to customers in a state where the seller has no actual place of business but otherwise has sufficient connection ("nexus") with that

state, the retailer is generally required to collect use tax from its customers and remit that tax to the state taxing authority.

Nexus: The requirement for sellers to comply with sales and use tax

Unlike US income tax, sales and use taxes are not covered by international tax treaties. Accordingly, any international business with customers and/or activities in the US should consider whether it has sales and use tax responsibilities in one or more US states. Currently, a business is required to comply with sales and use tax laws in only those states where they have the requisite connection or "nexus."

Traditional Nexus

In *Quill Corporation v. North Dakota*, 504 US 298 (1992), the US Supreme Court held that before an out-of-state company can be obligated to register and collect state use tax, it must have "substantial nexus" in the taxing state. This substantial nexus standard derives from the commerce clause of the US Constitution and requires some level of physical presence. In *Scripto v. Carson*, 362 US 207 (1960), the US Supreme Court sanctioned the agency theory of nexus, finding that an out-of-state seller who used independent contractors to solicit business could be required to collect the state's use tax. In *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 US 232 (1987), the US Supreme Court ruled that having representatives that perform activities on behalf of a seller while physically present in a state may create sales tax nexus for a seller if such activities are significantly associated with the seller's ability to establish and maintain a marketplace in the state for its sales.

Taken together, these decisions preclude a state from asserting the duty to collect sales or use tax upon an out-of-state seller absent proof that the out-of-state seller itself, or through an agent or representative soliciting on the out-of-state seller's behalf, is physically present in the state. In recent years, states have enacted nexus provisions that look to an agent's or representative's activities as they pertain specifically to internet sales solicitation and also through the shared activities of intercompany and/or affiliate entities.

'Click-through' and 'Affiliate' Nexus

New York became the first state in 2008 to enact what is sometimes called a "click-through" nexus statute. "Click-through" nexus statutes create a presumption of nexus for out-of-state sellers who compensate an in-state person based upon a commission arrangement for the placement of a hyperlink to the out-of-seller's website through the in-state company's website. The out-of-state seller may rebut the presumption provided it can document that the in-state person is not actively soliciting sales within the state on the out-of-state seller's behalf.

Additionally, some states have enacted "affiliate nexus" statutes that confer nexus on an out-of-state seller who is under common ownership with an in-state affiliate, when the affiliates share common logos and trademarks, or the in-state affiliate otherwise engages in activities that are deemed to expand the marketplace on behalf of the out-of-state affiliate.

States are not uniform in their enactment of these nexus provisions. Approximately 14 states have enacted click-through nexus laws, approximately 19 states have enacted affiliate nexus laws and one state administers both provisions via a policy statement. Accordingly, to determine its sales tax obligations, a seller should identify states in which it has traditional nexus via payroll and/or property, states in which the seller's representatives have a "regular and systematic" presence and states where click-through or affiliate nexus may apply.

The Changing Landscape of US Sales Tax: International projects & federal legislation

Both the United States Congress and the Organization for Economic Co-Operation and Development (OECD) have recognized that traditional approaches to indirect taxation may not be effective in the modern business economy. OECD recently released a series of non-binding recommendations to change domestic tax laws, treaties, and other measures in an effort to ease government concerns related to tax base erosion and profit shifting. With change appearing to be at the forefront of the international conversation, some taxpayers have begun to consider the potential impact on their state tax postures as states begin to react to the international tax discussion. While many of the OECD's deliverables focused on income tax, *Action 1, Addressing the Tax Challenges of the Digital Economy*, discusses indirect taxes, including sales and use tax. OECD has identified challenges associated with the digital economy, such as: (1) taxable nexus created by the mobility of intangibles, users, and business functions; (2) attribution stemming from the collection and use of data; and (3) characterization of payments in certain digital economic business models.[5] OECD has not yet resolved the perceived policy challenges associated with the digital economy.

Proposals for expanding sales and use tax nexus can also be seen at the US federal level. In the 113th Congress, the US Senate passed the Marketplace Fairness Act (MFA), which if adopted into law would generally allow Streamlined Sales and Use Tax Agreement member states as well as states adopting "minimum simplification requirements" to impose laws that would require remote sellers (i.e., sellers that have no physical presence in a particular state) to collect and remit sales/use taxes on sales to in-state residents. Also, if adopted, the MFA would provide an exemption for sellers with annual gross receipts from US remote sales of $1 million or less.

The 113th Congress expired on Jan. 3, 2015, having not passed the MFA. Thus, for the adoption of the MFA to remain a possibility, new legislation would have to be introduced and enacted by both the Senate and House of Representatives in a future Congress. Therefore, the form and timing of any potential Federal Legislation is unclear. It is noteworthy that in mid-November 2014, US House Speaker, John Boehner, had expressed his concerns with the MFA and vowed his resistance to taking up the measure during the final months of the 113th congressional session.

While the specific details of OECD recommendations or final US federal legislation are still unclear, both indicate that retaining a physical presence nexus standard for indirect taxes may not be practical in our modern digital economy. This is consistent with the states' adoption of click-through and affiliate nexus statutes that depart from the traditional physical presence model. At all levels, governments are recognizing that technological advances allow companies to carry out extensive economic activity in a jurisdiction without the need to be

[5] See OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing.

physically present in that jurisdiction. The ultimate goal of the taxing authorities is to ensure that revenue is taxed in the jurisdiction where the economic activities occur rather than in the jurisdiction where the seller chooses to locate its business.

A foreign-based multinational company that sells tangible personal property, software, or other digital products should be aware that, as a seller, it not only needs to identify the states in which it has payroll, property, or representatives with a “regular and systematic” presence, but also those states where it pays a commission to in-state companies for a referral to its website or has affiliates engaging in related business activities. These activities may result in a sales and use nexus determination pursuant to a state’s nexus rules. Such a determination would then require the foreign-based multinational company to register with the state tax agency, file sales/use tax returns, pay sales/use tax, and collect sales/use tax from its customers and remit that tax to the taxing agency. These same foreign-based multinational companies should monitor OECD’s recommendations, federal legislation, and state law changes for additional compliance requirements.

Structure and Administration of Sales and Use Taxes

Sales tax is collected by a seller from a customer when the transaction is subject to tax, unless the customer provides a customer-level or a transaction-level exemption certificate. Sellers are responsible for knowing what is taxable in the states in which they have nexus, collecting exemption certificates from customers to support a non-taxed sale, and remitting in a timely manner sales tax collected from customers on taxable sales. A transaction may be exempt because the customer making the purchase is exempt, because the type of transaction is exempt, or because the property or service being purchased or used is exempt.

A customer-level exemption is based upon the type of entity and whether it qualifies for an exemption. For example, a non-profit hospital or a school may be statutorily exempt from paying sales and use tax on its purchases. Some states may require such entities to apply and be approved for the exemption. The sale to certain statutorily exempt customers, such as the federal government, does not require an exemption certificate.

A transaction-level exemption is based upon the use of the product or service. For example, a sale to a customer who will resell a product without making any intervening use is generally considered an exempt sale for resale. Other common transaction-level exemptions are purchases used in an exempt activity such as manufacturing, research and development, or agriculture. The seller must collect an exemption certificate from the buyer to document the exempt nature of the transaction. The documentation requirements vary by state.

An exemption certificate is not normally required if the sale is statutorily exempt such as the sale of food for human consumption, prescription drugs, or certain medical devices, which are not taxable or are taxed at a lower rate in most states.

Sales and use tax is generally administered by each state’s Department of Revenue, although some municipalities self-administer a municipal-level sales tax. The tax rates, return filing frequency, and filing requirements are specific to each jurisdiction. Enforcement of the rules is state-specific, with most having an audit division that routinely reviews in-state and out-of-state seller compliance. State tax auditors often pay particular attention to the exemption documentation in support of non-taxed sales.

Product Taxability

It is the responsibility of businesses to understand how a state interprets and classifies the product or service it buys or sells within the scope of the state's sales tax regime. To demonstrate the complexity in applying taxability rules among various states, the example below depicts the sales tax treatment of the same item in different states. Each of the listed states taxes canned software delivered via a hard copy under the premise that the canned software meets the definition of tangible personal property and is thus subject to tax.[6] The same canned software that is delivered electronically is not deemed tangible personal property in California and is thus not taxable. Further the concept of Software as a Service (SaaS) can be classified under multiple taxation rules as discussed below.

Product	California	New York	Texas	Washington
Canned Software-delivered via tangible media	Taxable [Cal. Rev. & Tax Code §§ 6006(a), (b); Cal. Code Regs. tit. 18 § 1502(b)(9), (f)(1)]	Taxable [N.Y. Tax Law § 101(b) (5), (6), (14); N.Y. Tax Law § 1105(c)(1)]	Taxable [Tex. Tax Code Ann. § 151.005; Tex. Tax Code Ann. § 151.0101(a); 151.009; 34 Tax Admin. Code §§ 3.308(b)(1),(2)]	Taxable [RCW §82.05.050(6) (a); RCW § 82.12.020(1) (b); WAC § 458- 20-15502(3)]
Canned Software-delivered electronically	Not Taxable [Cal. Rev. & Tax Code §§ 6006(a), (b); Cal. Code Regs. tit. 18 § 1502(b)(9), (f)(1)(D)]	Taxable [N.Y. Tax Law § 1101(b) (5), (6), (14); N.Y. Tax Law § 1105(c)(1)]	Taxable [Tex. Tax Code Ann. § 151.005; Tex. Tax Code Ann. § 151.0101(a); 151.009; 34 Tax Admin. Code §§ 3.308(b)(1),(2)]	Taxable [RCW §82.05.050(6) (a); RCW § 82.12.020(1) (b); WAC § 458- 20-15502(3)]

[6] Cal. Rev. & Tax Code §§ 6006(a), (b); Cal. Code Regs. tit. 18 § 1502(b)(9), (f)(1); N.Y. Tax Law § 1101(b)(5), (6), (14); N.Y. Tax Law § 1105(c)(1); Tex. Tax Code Ann. § 151.005; Tex. Tax Code Ann. § 151.0101(a); 151.009; 34 Tax Admin. Code §§ 3.308(b)(1),(2); RCW § 82.05.050(6)(a); RCW § 82.12.020(1)(b); WAC § 458-20-15502(3).

Product	California	New York	Texas	Washington
SaaS	Not Taxable [Cal. Rev. & Tax Code §§ 6006(a), (b); Cal. Code Regs. tit. 18 § 1502(b)(9), (f)(1)(D)]	Not Taxable [N.Y. Tax Law § 1101 (b)(5), (6), (14); N.Y. Tax Law § 1105(c)(1)] N.Y. Reg. § 526.7 (a)(2); TSB-A-99 (31)S, New York Commissioner of Taxation and Finance (June 7, 1999); TSB-A-13 (22)S, New York Commissioner of Taxation and Finance (July 25, 2013)	Taxable – on 80% of the taxable base [34 Tax Admin. Code § 3.330; Tex. Letter No. 200805095L (May 28, 2008)]	Taxable [RCW §82.05.050(6) (a); RCW § 82.12.020(1) (b); WAC § 458- 20-15502(3)]

An interesting development involving software occurred recently in Texas where the Texas Comptroller of Public Accounts ruled that an out-of-state licensor's retained property rights in software licensed to Texas customers[7] created sufficient physical presence in Texas to constitute the substantial nexus necessary to subject the licensor to the obligation to charge, collect, and remit Texas use tax.[8]

Cloud-Based Services

Cloud computing services include products and services provided or furnished electronically such as SaaS, hosted software, cloud computing, web-enabled services, or other web-based items. While certain jurisdictions have directly addressed the taxability of cloud-based services, the seller is often left to fit its facts to statutes that were drafted to address the sale of traditional tangible personal property or at best, downloaded software.

States vary widely on the treatment of hosted products, defined generally as software that is installed and accessed from a remote server. Some states do not tax hosted products because no software has been deemed to have transferred, while other states consider hosted software to be a statutory sale of software regardless of the form delivered (i.e., electronically). Some states limit their tax base and do not tax other digitally based products while still others have extended their sales tax to a broad range of cloud technology. In addition, there may be other tax types to consider, such as telecommunication taxes, gross receipts taxes, or specific municipal taxes that could be applicable to these electronically delivered transactions.

[7] Delivery occurred either by digital download over the Internet or by common carrier.
[8] Texas Comptroller of Public Accounts, SOAH Docket No. 304-13-5657.26 (Sept. 19, 2014) at 18.

In determining what product or service is being sold, the seller should examine customer contracts, the terms and conditions to which the customers agree, and the applicable marketing and promotional materials.

Sourcing Rules

Sellers must also determine which state's sales tax rules apply to a given sale. A sale of tangible personal property, where title transfers to the customer at a seller's location and is shipped by common carrier, is generally sourced to the state in which the property comes to rest or at the customer's physical location (i.e., the destination state). Other sourcing rules may apply if the customer takes title at the seller's place of business, if the transaction involves a sale of service, or if the item sold is available for use in more than one place at a time, such as hosted software.

The Streamlined Sales Tax Agreement, a uniform agreement of definitions adopted as law in 24 states, contains cascading sourcing provisions to help enable the seller to make these determinations. For the 22 non-streamlined states, the sourcing rules vary. Still there may be separate rules that apply specifically where local taxes are involved.

Use Tax

A foreign-based multinational company may need to accrue use tax on purchases where its vendor did not collect sales tax. Use tax complements sales tax and is meant to provide equality among in-state and out-of-state sellers by imposing a use tax upon the customer in the event a seller did not charge the sales tax. Accordingly, a business needs to have a process in place to determine whether its purchases would be subject to use tax.

Action and Direction

The task of understanding the myriad of state rules, authorities, and requirements can be daunting. We recommend that businesses focus on the following important areas:

Structure: Review the legal entity structure to determine which entity is doing business in the US, including the relationship and shared activities between that entity and others within the organization and how the entity conducts or plans to conduct business in the US

Nexus: Determine states in which the entities have nexus, including traditional physical presence or nexus under the more recent click-through and affiliate nexus standards.

Taxability: Identify products and determine product taxability, including a thorough review of how the product or service may be conveyed or delivered. Also, determine whether use tax should be accrued on purchases consumed in the business' activities.

Sourcing: Understand where and how products are conveyed and what states' rules apply to the products being sold, paying careful consideration to cloud-based services.

Compliance Readiness: Analyzing sales and use tax compliance readiness before the MFA, or some other broad US federal law, is adopted may help identify gaps and improve processes and policies.

Automation: Understand and document the process flow from the general ledger to the source documents to ascertain whether sales and use tax compliance requirements are met within the current automated processes and to help identify compliance gaps. Determine whether third-party sales and use tax automation software could help to control and address the compliance reporting requirements.

Exemption Certificates: Review the current policy and processes for collection and retention of exemption documentation to assess the level of compliance. This analysis may involve gathering, updating, and tracking exemption certificates to support non-taxed sales, a key area for review in state sales and use tax audits and most often where errors are discovered.

While taxpayers and the tax community await the outcome of the OECD recommendations and possible US federal legislation, sellers should analyze potential tax exposure and tax reduction opportunities, while also considering implementation of improved processes in preparation for a likely scenario – that remote sellers with customers in the 45 states (and the District of Columbia) that impose a sales and use tax may in the near future face sales and use tax collection responsibilities in all such jurisdictions. A successful sales tax function is one where the seller proactively invests the time and appropriate resources to thoroughly review, assess, and determine the obligations of the business and take the steps necessary to establish a process to enhance tax compliance. An international company expanding business in the US is faced with many tax decisions. State sales tax rules are often the last item to be looked at and can be the most challenging to address. Implementing a process to review, understand, and comply with the state tax rules can make the difference in a business's ability to more fully capitalize on US consumer spending as opposed to paying those profits to state taxing authorities in the form of tax, interest, and penalties.

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Recent Developments Which May Affect Inbound Companies

The following are some miscellaneous developments which may have applicability to inbound companies.

IRS provides guidance on activities that occur at the retail level, which do not qualify for the Section 199 deduction

IRS' Large Business/International Division ("LB&I") has issued a directive that outlines certain activities not qualifying as qualified production property that is manufactured, produced, grown or extracted. Accordingly, such activities would not be qualified under Section 199.

Under Section 199, a taxpayer can take a deduction equal to 9% of the smaller of qualified production activities income (“QPAI”) or taxable income. In computing QPAI, a taxpayer subtracts the cost of goods sold from the domestic production gross receipts. Only gross receipts derived from the lease, rental, license, or sale of qualified property that has been manufactured, produced grown or extracted by the taxpayer in whole or significant part within the US, are qualified.

The IRS guidance indicates that the following activities performed at the retail level do not qualify for Section 199 benefits:

1. Cutting blank keys to a customer’s specification;
2. Mixing base paint and a paint coloring agent;
3. Applying garnishments to a cake that is not baked in the retail facility where it is sold;
4. Applying gas to agricultural products to slow or expedite fruit ripening;
5. Storing agricultural products in a controlled environment to extend shelf life; and
6. Maintaining plants and seedlings.

Taxpayers should be aware of this new directive, which may be an attempt by the IRS to challenge taxpayers who take an expansive view of qualified activities following the 2013 District Court decision in *Dean*. In that case, the Taxpayer assembled gift baskets sold to customers. The Court decided that the Taxpayer’s activities changed the form of an article and therefore qualified for a Section 199 deduction.

Taxpayers need to be careful when outsourcing payroll withholding and related deposits

It is very popular for companies to outsource their payroll functions to a third party service provider. This is often an efficient and a cost effective manner to relieve taxpayers of personnel hours devoted to payroll filings and related deadlines. Using a third party service provider has many benefits, but taxpayers need to take certain precautions since they are ultimately liable to the government for the tax, penalties and interest.

Typically a payroll service is hired to compute the withholding, maintain the tax payroll records and make the necessary filings along with making the payment on behalf of the taxpayer. There have been cases where the payroll service collected the money from the taxpayer but did not make the entire deposit to the various government agencies. Although the taxpayer relied on the payroll service to prepare and make the necessary filings and make the proper payments, the taxpayer was still liable for the tax, penalty and interest.

To assist taxpayers, the IRS has provided some guidance to taxpayers on their web page called “Outsourcing Payroll Duties” and suggests:

- Taxpayers should never change the address of record to the payroll services provider. If there is a problem with the account, IRS will send notification to the address of record. If the taxpayer has properly listed its address as the address of record, the taxpayer will receive notification of the issue.

- Taxpayer should make sure that the payroll service provider uses the EFTPS electronic payment system. In this manner, the taxpayers can review their account and check to see that the payments have been made.

Updated accounting method change procedures for taxpayers under audit and allowable automatic changes

On January 16, 2015, the Internal Revenue Service ("IRS") released Revenue Procedure ("Rev. Proc.") 2015-13 and Rev. Proc. 2015-14, which provide the procedures for taxpayers to change their methods of accounting under Section 446(e).

Rev. Proc. 2015-13 provides revised procedures to obtain the consent of the Commissioner to change a method of accounting. Rev. Proc. 2015-13 provides the procedures for filing both automatic method changes and non-automatic method changes. Subject to transition rules, the procedures are generally effective for accounting method changes filed on or after January 16, 2015 for tax years ending on or after May 31, 2014.

Rev. Proc. 2015-13 significantly modifies the procedures, terms, and conditions that apply to a taxpayer under examination that is filling an accounting method change. Under Rev. Proc. 2015-13, a taxpayer under examination may file an accounting method change request any time, but without back-year audit protection, unless the taxpayer meets one of six exceptions (in which case the change would have back-year audit protection). For a taxpayer that is not under examination, the procedures in Rev. Proc. 2015-13 are not significantly different from those in Rev. Proc. 97-27 and Rev. Proc. 2011-14.

Rev. Proc. 2015-13 generally retains the Section 481(a) adjustment spread periods under prior guidance – generally one year for a negative (favorable) adjustment and four years for a positive or (unfavorable) adjustment. The Section 481(a) adjustment spread period for a positive adjustment is reduced to two years for a taxpayer under examination filing outside of one of the six exceptions outlined in Rev. Proc. 2015-13.

The government included a number of transition rules for taxpayers that are particularly relevant for taxpayers considering making changes under the old 90-day window and for taxpayers making method changes to comply with the tangible property regulations or any other changes for which the prior scope limitations had been waived for a period of time.

Rev. Proc. 2015-14 provides the updated list of automatic accounting method changes and includes some new automatic method changes, and revises some of the changes that were previously included.

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Country Spotlight: Japan – 2015 Japanese tax reform proposals enacted

The 2015 tax reform proposals were enacted on 31 March 2015. Below is a short list of significant changes that may affect foreign based companies doing business in Japan and foreign nationals working in Japan.

Corporate Tax

1. Through reductions in both the national corporate tax rate and the local enterprise tax income levy rate, the effective corporate income tax rate in Japan for Tokyo-based companies with stated capital over JPY 100 million has decreased from 35.64% to 33.06% for fiscal years beginning on or after April 1, 2015 but before April 1, 2016 and then will further decrease from 33.06% to 32.26% for fiscal years beginning on or after April 1, 2016.
2. The amount of taxable income which may be offset with carried over tax losses will decrease gradually from 80% to 50% over the next 3 years starting with tax years beginning on or after 1 April 2015. However, the tax loss carryover period will increase from 9 years to 10 years for tax losses incurred in tax years beginning on or after 1 April 2017. The limitation on the use of the NOLs discussed above does not apply to small and medium-sized enterprises, certain tax qualifying investment vehicles, newly established entities and companies undergoing rehabilitation procedures.
3. The tax rates for both the Capital factor and Value Added factor of the factor based enterprise tax regime (which is imposed on companies with stated capital over JPY 100 million) will increase gradually from 0.2% to 0.4% and 0.48% to 0.96%, respectively, over the next two years starting with tax years beginning on or after 1 April 2015 (the tax rates for companies located in Tokyo would be slightly higher). A reduction of the Value Added factor tax base may be available for certain taxpayers that raise employee wages.
4. The ownership threshold required to fully exclude dividends received by a Japanese company from another Japanese company will increase from 25% or more to more than 33.3%. In addition, only 20% (currently, 50%) of dividends received from domestic shareholdings of 5% or less may be excluded from taxable income. Dividends received from domestic shareholdings of more than 5% up to 33.3% are eligible for a 50% exclusion.
5. The credit limit for general R&D costs is reduced to 25% of the corporation tax liability, with an additional 5% credit limit specifically in relation to special R&D costs. As for special R&D costs, a 20% credit is available for specified R&D costs and a higher 30% credit is available for R&D activities that are jointly carried out with or commissioned to national R&D institutions or universities. Also, the one year carry over for any excess R&D tax credit is abolished.
6. One of the requirements to take a tax credit for wage increases will be relaxed. Companies increasing wages by 4% (currently, 5%) over a specified base period for tax years beginning between 1 April 2016 and 31 March 2017 will be eligible for such tax credit provided other conditions are met. The increase is further reduced to 3% for Small and Medium Sized companies with stated capital of JPY 100 million or less.
7. Various tax incentives, including special depreciation and tax credits, will be provided to companies that invest in assets and hire employees in specified regional areas of Japan.

8. Additional measures related to the revisions to taxation of permanent establishments, which were included as part of the 2014 tax reform, will be introduced.
9. The 95% foreign dividend exemption regime will not apply to foreign dividends that are deductible in the payer's jurisdiction. This rule will generally be effective for tax years beginning on or after 1 April 2016. Grandfathering rules for existing shares will apply for periods beginning before 1 April 2018.
10. Among other changes to Japan's Controlled Foreign Corporation (CFC) regime, such regime will apply only if the effective tax rate of the CFC is less than 20% (currently, 20% or less).

Consumption Tax

1. The place of supply for cross-border digital services (e.g. provision of e-books and online advertising services) will change from the office of the supplier to the office or domicile of the recipient. The supply of cross-border digital services will be classified into business-to-business (B2B) supplies and business-to-consumer (B2C) supplies according to the nature of the service provided or the terms of the specific service contract. A reverse-charge mechanism will apply to B2B supplies, and recipients, instead of suppliers, will be liable to account for output JCT on the supply. The new rules will apply for transactions occurring on or after 1 October 2015.
2. The tax increase to 10% has been postponed by 18 months to 1 April 2017, and the "economic conditions" clause giving the government discretion to cancel the rate rise based on prevailing economic conditions has been removed. Also, a wide-ranging discussion will be launched towards the introduction of multiple JCT rates in 2017.

Individual Tax

1. Income tax will be levied on built-in gains in shares and certain other financial assets held by individuals who have maintained an address or a domicile in Japan for over 5 years in the preceding 10 years with covered assets worth more than JPY100 million when these individuals exit Japan. This rule will apply for individuals leaving Japan on or after 1 July 2015.
2. Additional documentation requirements will be imposed on individuals claiming a non-resident as a dependent on their income tax return.

For more information, visit the archives for the Deloitte publication, *Japan Inbound Tax Newsletter*, online.
URL: http://www2.deloitte.com/jp/en/pages/tax/articles/bt/japan-inbound-tax-newsletter.html

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Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

Recent and Upcoming Activities

June 10	Dbriefs webcast archive: Data Analytics: A Growing Imperative in the Rapidly Changing Global Transfer Pricing Environment Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2015/dbriefs-data-analytics-a-growing-imperative-in-the-rapidly-changing-global-transfer-pricing-environment.html?id=us:em:na:usic:eng:tax:072015
June 15	Dbriefs webcast archive: Data Analytics in M&A: Embracing the Cutting Edge for Competitive Advantage Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2015/dbriefs-data-analytics-in-mergers-and-acquisitions-embracing-the-cutting-edge-for-competitive-advantage.html?id=us:em:na:usic:eng:tax:072015
June 16	Dbriefs webcast archive: The Base Erosion and Profit Shifting Initiative: Individual Country Approaches Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2015/dbriefs-the-base-erosion-and-profit-shifting-initiative-individual-country-approaches.html?id=us:em:na:usic:eng:tax:072015
June 18	Dbriefs webcast archive: Global Tax Compliance and Statutory Accounting Reporting; Considerations for a Transformed Approach Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2015/dbriefs-global-tax-compliance-and-statutory-accounting-reporting-considerations-for-a-transformed-approach.html?id=us:em:na:usic:eng:tax:072015
June 29	Dbriefs webcast archive: Current Tax Accounting Challenges and Recent Legislative, Standard-setting, and Regulatory Developments Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2015/dbriefs-current-tax-accounting-challenges-and-recent-legislative-standard-setting-and-regulatory-developments.html?id=us:em:na:usic:eng:tax:072015
July 15	Dbriefs webcast archive: OECD Transfer Pricing guidelines: Nearing the finish line Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/july/2015/dbriefs-oecd-transfer-pricing-guidelines-nearing-the-finish-line.html?id=us:em:na:usic:eng:tax:072015

July 16	Dbriefs webcast archive: New IRS rules for accounting method changes: What companies need to know now Watch now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/july/2015/dbriefs-new-irs-rules-for-accounting-method-changes-what-companies-need-to-know-now.html?id=us:em:na:usic:eng:tax:072015
July 22	Dbriefs webcast: The evolving role of tax leadership: Understanding and acting on new expectations Register now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/july/2015/dbriefs-the-evolving-role-of-tax-leadership-understanding-and-acting-on-new-expectations.html?id=us:em:na:usic:eng:tax:072015
August 5	Dbriefs webcast: Net operating loss refunds: Important statute of limitation considerations Register now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2015/dbriefs-net-operating-loss-refunds-important-statute-of-limitation-considerations.html?id=us:em:na:usic:eng:tax:072015
August 22	Dbriefs webcast: Global payroll: Connecting the dots between payroll operations and individual compliance Register now http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/august/2015/dbriefs-global-payroll-connecting-the-dots-between-payroll-operations-and-individual-compliance.html?id=us:em:na:usic:eng:tax:072015

Recent Tax Developments

May 29	BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances OECD Tax Alert http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-29-may-2015.pdf

Have a question?
If you have needs specifically related to this newsletter's content, send us an email at clientsandmarketsdeloittetax@deloitte.com to have a Deloitte Tax professional contact you.

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