**In this issue:**



## Talking to Leaders, Boards and Investors About Tax Reform

As CFOs work through the impacts of the new tax reform legislation, a range of questions are emerging from management, boards and investors on how the new law could affect their organizations' business plans and performance. Drawing on experience as a CFO and board director, Charles Holley, independent senior advisor to Deloitte LLP and CFO-in-Residence of the CFO Program, and Rochelle Kleczynski, partner and National Tax Reform leader, Deloitte Tax LLP, discuss how CFOs can work with other executives and boards to address the potential implications of tax reform. They also offer insights on information boards are likely to seek from CFOs about tax reform, expectations of shareholders and activists, and operational issues for CFOs to consider.

**Q: What areas of tax reform should CFOs be discussing with leadership and investors to keep them informed about potential impacts?**

**Charles Holley:** From a strategic perspective, CFOs should keep other senior executives up to date on what the organization's tax structure might look like under the new law, and provide a high-level explanation of what it could take to restructure, as well as the impacts on the organization, such as shareholder value, financial performance and management's ability to execute the strategy. It's also important to discuss how much cash might be needed to meet tax obligations under the new law – which among other things, reduces the corporate tax rate to 21% – as well as options for using any excess cash generated by the lower rate or repatriating offshore cash.

Once a plan is in place to put excess cash to work, CFOs should work with investor relations on how to communicate the strategy to the investor community, as major shareholders and activist investors, in particular, will likely want to see how that cash is being used. It also could be wise to speak with the company's larger shareholders to understand their questions about tax reform's possible impact.

**Q: What might boards want their CFOs to discuss with them about tax reform?**

**Charles Holley:** Board members probably will want to review a very simple reconciliation between the statutory and effective tax rates and any significant initiatives implemented to drive the difference. The reconciliation should include a comparison of rates before and after tax reform was enacted. Boards also may be interested in seeing where consequential tax planning is taking place, and the potential benefits. For example, an organization that generates more of its earnings from operations outside the US than domestically might anticipate a very different effective tax rate under the new tax law, and boards may be interested in what tax planning strategies, if any, are being contemplated.

**Rochelle Kleczynski:** Boards also may request an assessment of major drivers on an organization's effective tax rate and what events could cause volatility. That assessment could include a peer analysis.

Also, because the tax law was enacted at the end of 2017, calendar year-end companies had to act quickly to record the impacts of the new tax law in their 2017 year-end financial statements. The SEC gave US registrants a year to finalize the accounting for the tax effects of the law that impact the 2017 financial statements. As guidance is issued and data is refined the calculations could change throughout the year. In addition, since guidance on major portions of the tax bill has not been released, CFOs should proactively explain that estimates may change and tax planning may evolve as more guidance is issued.

**Q: What other near-term issues may be affected by the uncertainty surrounding rule guidance?**

**Rochelle Kleczynski:** Most of the new tax law provisions are effective in 2018 and these calculations may be the most challenging for companies because some of the data needed may not be readily available and there is still a lot of uncertainty with how the rules work. That generally requires looking at taxable income calculated under US tax principles for foreign entities in light of the new provisions, which is something that has not been required previously. Some boards, as well as investors, may not understand that information needed for various calculations may have to be extracted from existing and new data sets, which will likely require time to assemble and analyze. CFOs may want to discuss with their audit committees the amount of effort and time re-measurement might take.

**Q: What are potential implications of tax reform for tax and treasury functions?**

**Charles Holley:** Tax functions will continue to play an important role in their organizations' business, and it's the CFO's responsibility to make sure that the CEO and board understand how the tax department might help the organization identify benefits that could be derived under the new tax provisions. Tax planning isn't going away because the rate went down. Further, tax departments may need additional, temporary resources to handle transitional activities, such as understanding new provisions, working through additional calculations and gathering new data to meet requirements of the new law. An increase in acquisitions, which some observers expect, also may call for providing more resources to tax teams that work on M&A due diligence, planning and integration activities.

Depending on what an organization decides to do with its domestic and international business models, liquidity and foreign exchange risks may change. Overall company liquidity may be reduced as excess cash offshore will be repatriated and redeployed. The treasury function likely will place more emphasis on capital structure, balance sheet optimization and ensuring liquidity forecasting is reliable.

**Q: Beyond finance and tax, how might other internal stakeholders and initiatives be affected by tax reform?**

**Charles Holley:** When I think about putting excess cash to work – including M&A, stock repurchases, dividend increases, capital investment and compensation – those are big initiatives that generally require cross-functional participation. CFOs may want to review their capital allocation plans in light of tax reform and take into consideration potential excess cash. First steps could include having a comprehensive view of enterprise value to help make the right decisions. A second step would include drawing up a comprehensive checklist to address tax reform implications affecting internal stakeholders, and setting up a mechanism to receive feedback about how the organization and individual departments are working through the checklist. The tax function would have an important seat at the table in that effort.

Some organizations likely will use excess cash to restructure and reorganize, and I expect to see a significant amount of initiatives focused on making organizations less reliant on manual processes. Along those lines, many companies might be considering investing more in innovative technologies because they were already on that path before tax reform was enacted. However, directing excess cash toward innovation should be done carefully, because you can't go from 0 to 100 when investing and expect efficiency.

The new provisions also brought new data requirements, so excess cash from tax reform may be an opportunity to upgrade enterprise resource planning systems, if an updated system would enhance processes for tax and other functions.

**Q: What are some strategic and operational issues that CFOs may have to address related to tax reform?**

**Charles Holley:** Organizations may want to consider the potential benefits – including tax and strategic as well as operational – of bringing back to the US intellectual property that's domiciled offshore and manufacturing facilities sited abroad.

In addition, it seems likely that the amount of cash expected to be repatriated, combined with the cash generated from the lower corporate rate, will lead to deal-making activity in coming months and competition for attractive acquisition targets. CFOs should be prepared to explain how any new transactions are not just a result of newly available cash, but how they fit into the corporate strategy and how they will contribute to long-term shareholder value.

**Rochelle Kleczynski:** Among the changes brought about by tax reform is the significant change to the deductibility of meals and entertainment expenses, which is likely to affect industries across the board. Its impact is not only a concern of finance, but also HR, and some organizations are taking another look at their policies to address the potential impact on employee recruitment and retention, and business development practices.

CFOs also may want to reconsider certain financial transactions and investments under the new interest expense limitation, which will eventually be reduced to 30% of EBIT. At that level, organizations may find themselves with a disallowance of interest expense. That could make a difference if the acquisition is funded with debt and the acquirer does not have the means to pay down the debt in a timely manner. In that situation, over leveraging the company could be a concern.

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## The Tax Cuts and Jobs Act: Untangling claims about the latest tax reform bill

The recently introduced tax reform bill has evoked mixed – and, sometimes, extreme – responses. So is it really great for the economy, as some believe, or is it simply increasing the wealth of high net worth individuals, as others claim? Here, we provide our perspectives on some commonly asked questions.

Want an advanced lesson in spin? Just listen to some people talking about the economic impact of the recent tax reform bill. Depending on who is speaking – or writing – it's either the greatest thing for the economy or it's a generous gift to people who do not need it. Any debate quickly gets caught up in a web of claims about economic data and models. In addition, part of the plan is temporary…maybe. So the plan's impact may look very different five or ten years from now. It all depends on whether a future Congress decides to make the "temporary" changes permanent.

Here's a guide to thinking about the impact of tax reform on the economy, and sorting out which claims are sensible and grounded in proven economic theory.

**Q: How do the tax changes affect the overall economy?**
**A:** The tax bill's economic impact operates through two channels. First, the tax cut in the bill reduces overall tax bills for many – but not all – individuals and businesses. Of course, the tax cut has to be financed by more federal borrowing. Second, the bill finances those changes in part by reducing many tax deductions.

**Q: Let's start with the tax cut, because everybody likes paying less taxes. Just how large is the tax cut?**
**A:** Individuals would get a net tax cut of $75 billion in 2018, out of total personal income of about $18 trillion, rising to $139 billion by 2025. Businesses would get a net tax cut of $130 billion in 2018, but the tax cut would be about $49 billion by 2027.[1] Some of the business tax cut is offset by higher tax collections on the international income of US corporations.

**Q: Why did you give the individual tax cut for 2025 but the business tax cut for 2027?**
**A:** Most of the individual tax changes are reversed after 2025. In fact, the Joint Committee on Taxation (JCT) estimates that net individual tax collections will be $83 billion higher in 2027 than if the tax plan had not been adopted. This is also true for one key part of the business tax change. "Bonus depreciation," which allows businesses to write off investments more quickly than normal, will be phased out starting in 2023 and will go away completely after 2026. And "bonus depreciation" allows businesses to lower their taxes today at the expense of higher taxes in later years (when they would have had depreciation to expense, had they not used it earlier).

**Q: Who came up with those numbers?**
**A:** The staff of a Congressional Committee called the Joint Committee on Taxation (JCT) has the job of estimating the "cost" of any proposal to change tax laws. The staff – which is nonpartisan – has deep expertise in modeling and estimating the impact of tax changes. The changes are estimated for a 10-year horizon, reflecting Congressional rules about budgeting.

**Q: More money in the pockets of businesses and individuals sounds like it should make GDP grow faster. How much growth will it create?**
**A:** No question about it, the "tax cut" part of the bill will create some extra economic activity. Additional business cash flow is likely to create more investment spending,[2] and higher after-tax incomes will induce households to spend more on goods and services. This is the demand side impact of the tax bill. By some estimates, it could be fairly large in the

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[1] Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the Tax Cut and Jobs Act*, JCX-67-17, December 18, 2017. Personal income is as projected by the Congressional Budget Office in June 2017. "Business" and "individual" tax changes are measured as defined by the JCT, although some of the individual tax change is because individuals can receive a tax break on profits from "pass-through" businesses.
[2] Some economists observe that corporate cash flow has been very healthy without much impact on investment in the past few years – and that adding to cash flow may not have the anticipated effect. The models are based on behavior in the past, when corporations were more sensitive to cash flow – so the results in all of these models may overstate the short-term demand-side impact of the tax bill.

short run. The International Monetary Fund, for example, estimates that US GDP will be 1.2 percent higher in 2020 because of the additional demand.[3]

**Q: Wait, why did you emphasize "short run"?**
**A:** Because the demand side impact is likely to go away. Once the economy reaches capacity, additional demand creates inflation, not more growth.

**Q: But isn't the economy already close to capacity? How can it grow faster if there is a labor shortage?**
**A:** There probably isn't a labor shortage yet.[4] Many people – including the staff and officials at the Federal Reserve – think we may be getting close. That means that the Federal Reserve is becoming more worried about the possibility of inflation. The additional demand from the tax cut may convince Fed officials to raise interest rates faster than they otherwise would have, and that might moderate the growth impact of the tax cut.

**Q: But won't lowering the tax rate and making the tax code more business-friendly increase investment and the capacity of the economy?**
**A:** Yes, it's not just putting money in people's pockets. There should be a supply side impact from this tax cut – a reduction in the cost of investing that will convince organizations to invest more, increasing productivity.

**Q: How large is the supply side impact?**
**A:** It's likely to be much smaller than the demand side impact in the next few years. However, after 10 years, the demand side impact will likely have dissipated, and the only impact we will see is on the supply side.

Table 1 compares the estimated impact after 10 years from four different organizations that use "dynamic scoring" to analyze the impact of the tax cut. The estimates range so widely because the different models make different assumptions about taxpayer behavior. The Tax Foundation's estimates imply that GDP growth could be approximately 0.3 percentage points greater per year with the new tax bill (2.3 percent, for example, rather than 2.0 percent) while the JCT's estimates suggest almost no impact.

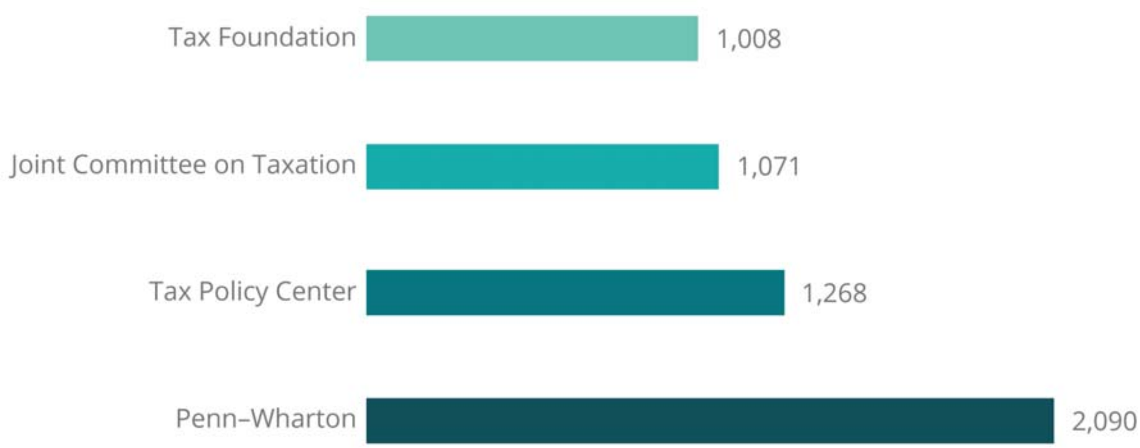
**Table 1. Estimated GDP impact of the tax bill by 2027, with dynamic scoring**[5]

| Estimator | Impact on GDP after 10 years |
|---|---|
| Joint Committee on Taxation | 0.1% to 0.2% |
| Tax Foundation | 2.8% |
| Penn-Wharton Budget Model | 0.6% to 1.1% |
| Tax Policy Center | 0.0% |

**Q: Doesn't the tax bill add to the long-term debt problem?**
**A:** Yes. Even under the most optimistic assumptions, the federal debt is projected to be higher in 2027 than it would have been had the tax bill not passed. Figure 1 compares projections for the debt by the different estimators. The figure shows that all models indicate the tax bill raising total US government debt by at least $1 trillion.

[3] International Monetary Fund, *World Economic Outlook Update: Brighter prospects, optimistic markets, challenges ahead*, January 2018.
[4] For more on this question, please see Daniel Bachman, *Where's the labor shortage?*, Deloitte Insights, December 18, 2017.
**URL:** https://www2.deloitte.com/insights/us/en/economy/behind-the-numbers/understanding-labor-shortage-economists-versus-business.html?id=us:2em:3na:usic:awa:tax:041618
[5] Tax Foundation, *Preliminary details and analysis of the Tax Cuts and Jobs Act*, special report no. 241, December 2017; Penn Wharton Budget Model, *The Tax Cuts and Jobs Act, as reported by conference committee (12/15/17): Static and dynamic effects on the budget and economy*; Benjamin R. Page et al., *Macroeconomic analysis of the Tax Cut and Jobs Act*, Tax Policy Center, December 20, 2017; Joint Committee on Taxation, *Macroeconomic analysis of the conference agreement for H.R. 1, the Tax Cuts and Jobs Act*, JCX-69-17, December 22, 2017.

**Figure 1. Increase in federal debt after 10 years by estimator ($ billion)**




Source: Joint Committee on Taxation, Tax Foundation, Penn Wharton Budget Model, and Tax Policy Center.

**Q: Does the tax bill only benefit wealthy people?**
**A:** That depends on whether the temporary individual tax changes are included. Figure 2 shows the impact on the average taxpayer[6] in each income class in 2019 (when the individual tax changes are in place) and in 2027 (when most of the individual changes will have been reversed).[7] Initially, average taxpayers at all income levels will receive cuts, with the largest percentage decline going to relatively low-income taxpayers – those with incomes between $20,000 and $30,000 per year. After the individual tax changes are reversed, however, those same low-income taxpayers face a rise in tax payments (27 percent for the $20,000 – $30,000 income range) compared to the current law. (That is due to the complicated impact of the permanent repeal of the penalty for not buying health insurance.[8])

Of course, most taxpayers are not average. Actual experience will depend on the specifics of each taxpayer's situation.

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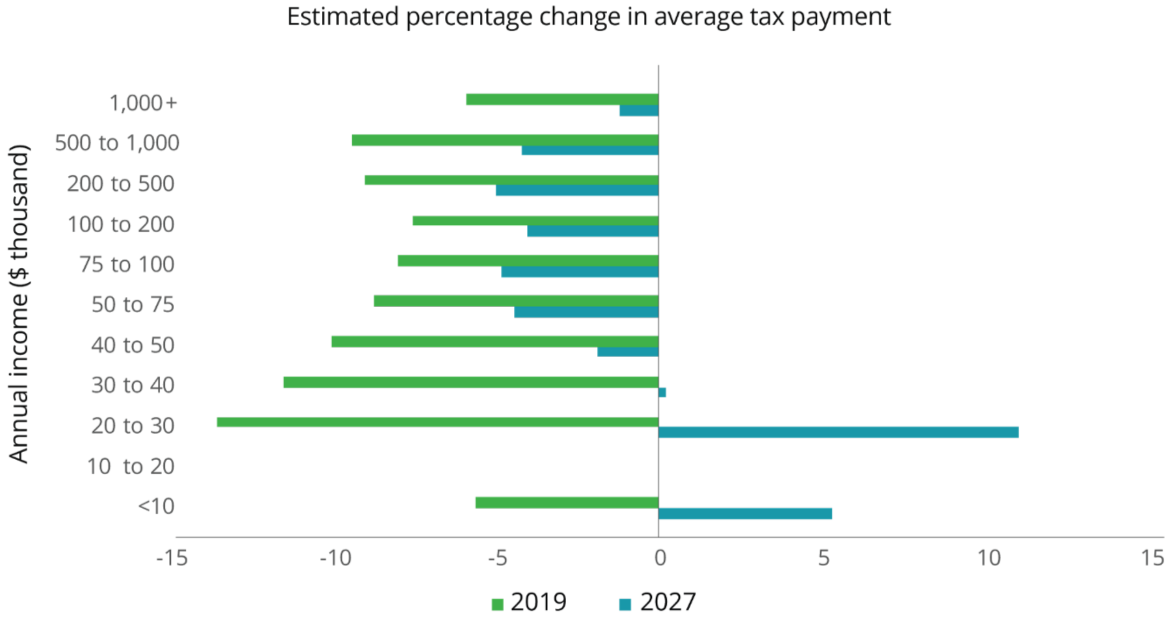
[6] Total number of estimated taxpayers divided by the actual number of taxpayers.
[7] Joint Committee on Taxation, *Distributional effects of the conference agreement for H.R. 1, The Tax Cuts and Jobs Act*, JCX-68-17, December 18, 2017.
[8] The bill permanently repeals the Affordable Care Act's mandate that individuals pay a penalty if they don't have qualifying health insurance. Repealing the mandate leads fewer people to buy insurance, and many of those not buying coverage would have done so with refundable tax credits; the fact they won't be claiming those credits in the future is "scored" as a net tax increase.

**Figure 2. Tax reform impact by income class**




Source: Joint committee on Taxation

**Q: As always, economists make things complicated. Let's cut to the chase. What's your "elevator speech" about the economic impact of the Tax Cut and Jobs Act?**
**A:** Most of the research agrees that there will be a modest, but significant boost to growth in the short run. By the end of the 10-year horizon – and beyond – the impact will likely be small at best. Despite some provisions' negative impact on high-income households (e.g., marriage penalty and disallowance of state and local deductions), the bill appears to provide the most benefits to people in upper-middle-income classes – although if the individual changes become permanent, people in lower brackets will benefit in the long run as well. However, the additional long-run debt may cause problems for the United States further down the road.

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## California FTB Issues Preliminary Report on California's Conformity to Various Provisions of the Federal Tax Reform Act

### Overview

On December 22, 2017, President Trump signed into law P.L. 115-97 "The 2017 Tax Reform Act" ("the Act"). On February, 12, 2018, the California Franchise Tax Board ("FTB") issued a Preliminary Report on Specific Provisions of the Act, Part 1 ("Preliminary Report") that addresses, among others, California Corporation Tax Law ("CTL") conformity or lack thereof to certain provisions in the Act.
**URL:** https://www.ftb.ca.gov/aboutFTB/newsroom/Preliminary-Review-of-Federal-Tax-Reform-Part-1.pdf

In the Preliminary Report, the FTB notes that the CTL conforms generally to the IRC as of January 1, 2015, with one notable exception. In instances where California's water's-edge provisions refer to an IRC provision, "it is the IRC provision in effect for the same taxable period." However, neither existing CTL nor the water's-edge provisions within the CTL incorporate by reference (or specifically refer to) the new federal repatriation provisions found under IRC

Sections 245A, 951A, and 965. Therefore, the FTB states that neither existing CTL nor California water's edge provisions conform to the federal repatriation provisions added by the federal Tax Act.

In the light of this nonconformity, the Preliminary Report concludes with an estimate of the potential impact upon California corporate tax revenues given the expectation that "many taxpayers may have an extraordinary repatriation dividend." Acknowledging the many variables and uncertainties which impact such a projection, the FTB estimates that the tax revenue increase by fiscal year would be $50 million in 2017-2018, $150 million in 2018-2019, $110 million in 2018-2019, and $40 million in 2019-2020.

The FTB also indicates that it plans to issue additional reports addressing California's conformity to other provisions in the Tax Act on or before March 2, 2018, March 26, 2018, and April 20, 2018.

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## Update on US payroll implications of US tax reform: 2018 Form W-4 issued

### Overview

The Internal Revenue Service (IRS) has issued a new 2018 Form W-4, following the earlier release of new income tax withholding tables, to employers as a result of tax reform legislation ("An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018") (the "Act").

Although not all employees will need to complete the new form for 2018, the IRS is encouraging all employees to perform a "paycheck checkup" to review their withholding position. Those employees with more complicated personal circumstances likely will need to file a new Form W-4. Those with more straightforward personal circumstances (e.g., single filing status and no dependents) likely will not need to take any action.

This NewsFlash provides a consolidated summary of the most recent Form W-4 changes announced by the IRS and how employers should respond.

### What's changing?

In addition to the reduction of income tax rates, individual income tax withholding may be impacted by other changes in the Act, including:

- Elimination of personal exemptions and increased standard deduction
- Limitations on the itemized deductions available for state and local taxes, mortgage interest, and medical expenses.
- A new child tax credit calculation, with increased credit phase-out amounts.

To address these changes and their potential impact on withholding, a new Form W-4 has been issued for 2018, enabling employees to calculate the number of withholding allowances they will now be entitled. To support individuals with completing the new form, the IRS has made available a withholding calculator that helps determine tax withholdings and provides guidance on how to complete Form W-4, along with FAQs.

Individuals with more complex situations are advised to consult Publication 505 once the IRS publishes an updated version. Complex situations may include individuals who owe self-employment tax, are subject to Alternative Minimum Tax (AMT) or are entitled to claim an AMT credit, and individuals with capital gains and dividends.

**What does this mean for employees and employers?**

Employers will need to ensure they make the new form available to their employees and direct them to the available IRS guidance on completing the form. These forms are typically made available through internal company websites.

All employees are advised by the IRS to check their position, and can use the IRS tools to do so, but not all will need to change the last Form W-4 they previously submitted. High-risk groups cited by the IRS who will likely need to make a change are:

- Families with more than one earner;
- People with two or more jobs at the same time or who only work for part of the year;
- People with children who claim credits such as the Child Tax Credit;
- People with older dependents, including children 17 or older;
- People who itemized deductions in 2017; and
- People with high income and more complex tax returns.

Employers with employees in states with high income tax rates (and therefore a higher proportion of employees that have historically itemized income tax deductions) are likely to have more new Forms W-4 to process than others. There will likely be an additional second wave of Forms W-4 submitted by employees once the 2017 tax returns are completed and Publication 505 becomes available.

**Deloitte's view**

While the IRS previously stated that employees would not be required to file a new Form W-4 for 2018, it now seems quite clear, as expected, that many employees with more complex personal circumstances should review the IRS guidance and file a new form. This review will help ensure that employees are not underwithheld and can mitigate underpayment penalties.

Employers will need to make the new form available as soon as possible, and should be prepared to answer questions posed by employees regarding the new forms. The extent to which employers will want to respond to those questions versus suggesting employees consult an outside source (e.g., a tax adviser or the IRS website) will depend on the organization's historical approach to answering employee tax questions and the likely expected volume of employee queries.

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## The US Internal Revenue Service on 30 March 2018 released Announcement 2018-08: The Advanced Pricing Agreement Annual Report

The US Internal Revenue Service (IRS) on 30 March 2018 released Announcement 2018-08, the advance pricing agreement (APA) annual report covering the activities of the Advance Pricing and Mutual Agreement (APMA) Program during calendar year 2017. The annual report is issued under §521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APMA Program.
**URL:** https://www.irs.gov/pub/irs-drop/a-18-08.pdf

The annual report provides a summary of recent APA developments in the APMA Program and a statistical snapshot of the program's APA activities during 2017.

Transfer pricing enforcement is expected to increase throughout the world as countries adopt the OECD BEPS final recommendations, including the enactment of country-by-country (CbC) reporting requirements. In addition, many US and foreign multinational groups have begun reviewing their existing structures and transfer pricing policies in light of the passage of the 2017 Tax Act (Pub. L. No. 115-97), which may result in operational restructurings and transfer pricing policy changes. The act includes several new international tax provisions that have created complex transfer pricing and international tax issues for both US and foreign multinational groups. Consequently, the certainty provided by APAs will play an increasingly important role in transfer pricing risk management.

Statistical highlights of the APA annual report include:

- **Incoming APA requests:** The IRS received 101 APA applications (14 unilateral, 86 bilateral, and 1 multilateral) in 2017, a similar number to the 98 APA applications received in 2016.
- **Large increase in completed APAs:** During the 2017 calendar year, APMA closed 116 APAs (30 unilateral, 85 bilateral, and 1 multilateral), compared to 86 APAs in 2016 and 110 APAs in 2015, while reporting a decrease in staffing levels in the APMA Program at the end of 2017 compared to the end of 2016. APA renewals accounted for 70 of the 116 APAs executed (or just over 60%), with 22 unilateral and 48 bilateral renewals. Twenty-two percent of all APAs included rollbacks. It is likely that a significant portion of APAs with rollbacks resolved transfer pricing audit activity involving either the IRS or the tax authorities of a treaty partner.
- **Treaty partners involved in bilateral APAs:** In 2017 Japan accounted for 38% of bilateral APA requests filed, the largest share of any country. India accounted for 21%, showing the continued popularity of US-India bilateral APA requests since the IRS began accepting applications for bilateral APAs with India in February 2016. Other countries accounting for meaningful percentages of filed, pending, or completed APAs with the United States are Canada, China, Germany, Korea, Mexico, Switzerland, and the United Kingdom. Nearly three-quarters of the total number of bilateral APAs executed in 2017 involved bilateral APAs with either Japan or Canada. Based on the filed APA requests during 2017 and the IRS's pending inventory of APAs, the percentage of completed APAs with Japan and Canada is expected to decrease as a percentage of the total as other countries become more active in the APA process.
- **Months to complete APAs:** In 2017, the median time to complete a unilateral APA and a bilateral APA was 31.0 months and 35.9 months, respectively. In 2016, the median time to complete a unilateral APA and a bilateral APA was 15.4 months and 35.6 months, respectively. Overall, the median time required to complete the 116 APAs executed in 2017 was 33.8 months, one month slower than in 2016. Processing time for unilateral APAs increased significantly from the prior year. Unlike bilateral APAs, which involve treaty partners, unilateral APAs and their processing time are more controlled by APMA. Due to significantly smaller volumes of unilateral APAs compared to bilateral APAs, the median processing time for unilateral APAs tends to exhibit higher levels of variability than for bilateral APAs. Processing time for bilateral APAs increased slightly from the prior year. For each of the last five years, the median processing time for bilateral APAs has ranged from approximately 35 months to 38 months. Taxpayers renewing APAs benefitted from faster processing times for their APA requests. For renewal unilateral and bilateral APAs, the median processing time was 30.5 months, compared to the median processing time for new unilateral and bilateral APAs of 43.0 months. The median processing time required to complete new APAs decreased slightly from 46.7 months in 2016 to 43.0 months in 2017.
- **APA inventory:** The APMA Program had 386 cases in active inventory at the end of 2017: 57 unilateral APAs, 321 bilateral APAs, and 8 multilateral APAs. The number of pending APAs has continued to decline since 2015.
- **Term length of APAs (including rollback years):** Of the APAs executed in 2017, 38 cases had a five-year term including rollback years, while 68 cases had terms of six years or longer. The average term length in 2017 was seven years, compared to six years in the previous year. In our experience, the APMA Program and foreign competent authorities are willing to extend the standard APA term of five years when additional years are needed to address difficult results during a rollback period and/or completed APA years, or to provide some prospectivity in cases when the APA request took a long time to complete. Further, in the context of renewal APAs that were handled expeditiously, the APMA Program has shown a willingness to accept APA terms longer than five years.
- **Staffing:** As of 30 December 2017, the APMA Program was comprised of 55 team leaders, 17 economists, and 10 senior managers organized into 10 groups (seven team leader groups and three economist groups). Compared to 2016, this represents a decrease of seven team leaders and three economists. The team leader groups are organized by country, with each group having responsibility for multiple countries. Because of the large volume of cases with certain treaty partners, some countries are the responsibility of more than one group.

- **Cancellations, revocations, and withdrawals:** No APAs were cancelled or revoked during 2017. Eight APA requests (one unilateral, six bilateral, and one multilateral) were withdrawn in 2017, which is significantly lower than the 24 applications withdrawn in 2016, and more consistent with the 10 applications withdrawn in 2015.
- **APAs executed by industry:** In 2017, manufacturing and wholesale/retail trade accounted for 41% and 37%, respectively, of the total number of executed APAs. Within the wholesale/retail trade industry, merchant wholesalers of durable goods were most common (77% of such cases).
- **Covered transactions and transfer pricing methods:** Forty-four percent of the transactions covered in APAs executed in 2017 involved the sale of tangible goods, 35% involved the provision of services, and 21% involved the use of intangible property, which is consistent with the covered transactions in 2016. For potential cost sharing APAs, taxpayers should also consider that the preamble to the final cost sharing regulations under Treas. Reg. §1.482-7 provides that the IRS has the authority to negotiate an APA covering a platform contribution transaction and include a commensurate with income waiver. The comparable profits method (CPM) was used to evaluate 87% of the transactions involving the transfer of tangible and intangible property in 2017. Of those transactions, 85% used the operating margin as the profit level indicator (PLI) and 15% used other PLIs, such as the Berry ratio and return on assets or capital employed. For services transactions, the most frequently applied method was also the CPM (86% of cases). Of those services transactions applying the CPM, 62% used the operating margin as the PLI. In 2017, the majority of APAs that covered services transactions also included tangible or intangible transactions, which were not tested under a separate PLI.
- **Adjustment mechanisms:** The majority of the transactions covered in APAs executed in 2017 target an interquartile range. Those APAs include a number of mechanisms for making adjustments to the tested party's results when the results fall outside the range or do not match the point required by the APA. Some examples of the mechanisms included in the 2017 executed APAs include an adjustment bringing the tested party's results to the closest edge of the range applied to the results of a single year, an adjustment to the closest edge of the range applied to the results over the APA term, an adjustment to the specified point or royalty rate, and an adjustment to the median of the range for a single year.
- **APA boilerplate and APMA Program contact information:** The annual report also includes the latest version of the APMA Program's model APA agreement and a link to the list of primary APMA Program contacts. The model APA agreement has been unchanged since 2009; however, APMA solicited comments on a proposed major revision in September 2017, which has yet to be finalized.

The APMA Program also recently announced a significant increase in user fees to request an APA, for user fees paid after 30 June 2018, and 31 December 2018. Taxpayers that are planning to request an APA in the next 12 to 18 months should consider expediting the payment of the APA user fee prior to those dates, through what is known as a "dollar file" APA request, to take advantage of the existing lower user fees.

In light of the BEPS final reports and the adoption of CbC reporting requirements by many jurisdictions and corresponding increased audit activity, the demand for APAs will undoubtedly continue to be strong.

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## European Commission proposes tax on digital services, structural changes to PE rules

On 21 March 2018, the European Commission issued two draft directives on the taxation of the digital economy. Under the proposed new long-term comprehensive solution, companies would have to pay corporate income tax in each EU member state where they have a significant digital presence. In the interim, the Commission proposes a 3% revenue-based digital services tax on specific digital services where the main value is created through user participation. The Commission aims for an effective date of the interim measures on 1 January 2020.

**Background**

The European Commission's proposal is based on the fact that companies offering digital services in the EU may pay no or little tax on their profits in the country where the value of the services is created. One reason for this is that the service provider often has no physical presence in the country where the services are performed, which may mean that there is no possibility for that country to tax the related profits under current tax rules. The Commission considers this outcome to be undesirable, and it intends to structurally change the concept of a permanent establishment (PE) to prevent this result. Specifically, the supply of such services would create a deemed PE – a "digital" or "virtual" PE – linked to specific transfer pricing rules for digital services. These structural changes would be complex and would take time to implement, so the Commission is proposing an interim solution that would tax the gross revenue derived from digital services.

The proposal for an EU-wide digital services tax would generate revenues estimated to be worth up to EUR 5 million a year across the EU and help avoid a patchwork of unilateral actions that could fragment the single market and create uncertainty for businesses.

**Interim tax on digital services**

**Scope of tax:** Pending multilateral, international solutions to taxing the digital economy, the European Commission is proposing a 3% digital services tax on the gross revenue resulting from the supply of certain digital services characterized by user value creation:

- Online placement of advertising;
- Sale of collected user data; and
- Digital platforms that facilitate interaction between users that then can exchange goods and services directly via the platform.

The provision of digital content, payment services, online sales goods or services, and certain regulated financial and crowdfunding services are specifically excluded from the new digital services tax.

The measure is targeted at businesses with:

- Sufficient scale that established strong market positions allow them to benefit relatively more from network effects and exploitation of big data, i.e. those with total consolidated annual global revenues exceeding EUR 750 million; and
- A significant digital footprint in the EU, i.e. those with annual revenues from taxable digital activities in the EU exceeding EUR 50 million.

The digital services tax would apply irrespective of whether a business is established within the EU.

**Place of supply of services:** The following rules would apply to determine the place where the services would be deemed to be supplied, and where the tax would be due:

- For services involving the provision of user data collected by means of making advertising space available, or the sale of data: Where the advertisement is displayed or where the users that supplied the data that is being sold are located; and
- For services involving making available digital platforms/marketplaces to users: Where the user paying for access to the platform (or to conclude a transaction within the platform) is located.

In situations where two platform users are involved in an underlying transaction, they are paying for the use of the platform and are resident in different EU member states, the digital services tax would be levied in both member states on the amount of revenue generated in each.

In line with the concept of user value creation, the digital services tax would be payable to the member state where the users are located. Where users are in different member states, one member state would be responsible for collecting the tax and allocating it to the other member states, based on allocation keys.

**Tax administration:** The annual gross revenue derived from digital services would be taxed at a rate of 3%. Thus, individual transactions would not be taxed, and there would be no deductions for costs incurred. It would not be possible to settle any tax levied at an earlier stage of the supply, but the tax would be deductible as an expense for corporate income tax purposes.

Additional reporting requirements would need to be imposed due to the specific information EU member states would need to levy the digital services tax. A single EU-wide payment and reporting portal would be established, based on the one-stop-shop model currently used for VAT purposes, meaning that all information would need to be provided to only a single member state that subsequently would exchange the information with other affected member states. Businesses would be required to self-assess the tax liability and pay it on an annual basis. Consolidated groups would be able to nominate one company to deal with compliance and payment.

**Longer-term structural changes to taxation of digital services**

In a separate draft directive, the European Commission is proposing common EU rules to allow member states to tax profits generated from a significant digital or "virtual" presence in their jurisdiction, regardless of physical presence. The proposed significant digital presence concept builds on existing international tax principles to create a new category of PE in respect of a broad range of digital services.

The proposal would extend the current PE rules by establishing a taxable nexus for digital businesses operating across borders where at least one of the following conditions is fulfilled with respect to a tax year:

- Revenues from digital services provided to users located in a member state exceed EUR 7 million;
- Number of active users of digital services located in a member state exceeds 100,000; or
- Number of business contracts for digital services concluded by users located in a member state exceeds 3,000.

The definition of digital services would follow that used for VAT purposes under the EU VAT directive.

These thresholds would apply by reference to the activities of the services supplied by the entity itself aggregated with those supplied by any associated enterprises. The associated enterprises test would be broad and include cases of significant influence through participation in management, a direct or an indirect holding that exceeds 20% of voting rights, or participation in the capital through a direct or indirect right of ownership that exceeds 20% of the capital.

According to the European Commission, the structural tax changes to the PE concept eventually should be included in the proposal for a common consolidated corporate tax base (so that taxable profits are allocated in proportion of the share of activity of an EU member state). EU member states also would have to implement the rules on digital PEs and profit allocation for corporate income tax purposes.

"Anti-fragmentation" rules would be introduced to prevent tax avoidance.

**Profit allocation:** The profit allocation rules relating to digital services would be aligned with the OECD transfer pricing guidelines. The basic assumption would be that profits should be taxed where value is created. In terms of digital services, the commission intends to relate value creation to the location where the buyers of the digital services are established and data is collected and processed. To this end, additional criteria for profit allocation would be developed, focusing specifically on digital services, which could relate to:

- Users' engagement and contributions to a platform;
- Data collected from users in an EU member state through a digital platform;
- Number of users; and
- Amount of user-generated content.

**Comments**

The European Commission intends that the directive would require the amendment of tax treaties between EU member states, and that also would apply to transactions between member states and third countries that have not concluded tax treaties with member states. In cases where there is a tax treaty between an EU member state and a third country, the Commission intends to recommend that the member state apply the measures by amending the tax treaty. The European Commission would seek to have the changes incorporated into the OECD model tax treaty through amendments to articles 5 (permanent establishment) and 7 (business profits).

Unanimous approval by all member states is required for the adoption of the proposed directives. It is unclear when the measures would effectively be introduced, but as noted above, the Commission aims for an effective date of the interim measures on 1 January 2020.

The EU would prefer rules agreed at the global level but considers that an unacceptable amount of profits is currently untaxed and, therefore, has proposed solutions at an EU level. Notable, the EU proposals were released within days of the OECD's Tax Challenges Arising from Digitalization: Interim Report 2018, and the European Commission intends that its latest proposals will contribute to the ongoing work at the OECD level to influence international discussions on a global solution.

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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**

**March 28**
12:00 p.m. ET

**Dbriefs archive:** (Special Edition) Transfer pricing and global tax reforms: Emerging hot topics
Watch
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/march/2018/dbriefs-transfer-pricing-and-global-tax-reforms-emerging-hot-topics.html?id=us:2em:3na:usic:awa:tax:041618

**April 5**
11:00 a.m. ET

**Dbriefs archive:** US tax reform: What does it mean for Chinese investors?
Watch
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/april/2018/dbriefs-us-tax-reform-what-does-it-mean-for-chinese-investors.html?id=us:2em:3na:usic:awa:tax:041618

**April 10**
2:00 p.m. ET

**Dbriefs archive:** Global payroll operations: Improving efficiency and tax compliance
Watch
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/april/2018/dbriefs-global-payroll-operations-improving-efficiency-and-tax-compliance.html?id=us:2em:3na:usic:awa:tax:041618

**April 25**
2:00 p.m. ET

**Dbriefs webcast:** Operationalizing US tax reform: Creating a sustainable tax ecosystem
Register
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/april/2018/dbriefs-operationalizing-us-tax-reform-creating-a-sustainable-tax-ecosystem.html?id=us:2em:3na:usic:awa:tax:041618

**May 2**
2:00 p.m. ET

**Dbriefs webcast:** Quarterly federal tax roundup: A pass-throughs update
Register
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/may/2018/dbriefs-quarterly-federal-tax-roundup-a-pass-throughs-update.html?id=us:2em:3na:usic:awa:tax:041618

**May 17**
2:00 p.m. ET

**Dbriefs webcast:** Migration to the Oracle Cloud: Opportunities for tax
Register
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/may/2018/dbriefs-migration-to-the-oracle-cloud-opportunities-for-tax.html?id=us:2em:3na:usic:awa:tax:041618

**May 31**
2:00 p.m. ET

**Dbriefs webcast:** US tax reform: Emerging issues on the international front
Register
**URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/may/2018/dbriefs-us-tax-reform-emerging-issues-on-the-international-front.html?id=us:2em:3na:usic:awa:tax:041618