At the intersection of international tax and digital transformation

OECD BEPS Project: New world order or open season?

EY
Building a better working world

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EY is a regular contributor to CCH's *Global Tax Weekly*. As tax and technology professionals, from member firms around the world, we share our insight and technology perspective on topics of interest to executives faced with taxation issues resulting from disruptive innovation and technology-enabled digital transformation. The content contained in this document was first published in *Global Tax Weekly* – and is being reprinted with full knowledge and permission from Wolters Kluwer, copyright 2015 CCH.

In this edition

This edition of our regular column explores some of these early patterns in digital economy taxation. These local country and international dynamics present fundamental considerations for tax practitioners and international finance executives:

1. You need to understand the level of uncertainty you face in monitoring and preparing for ongoing change in digital economy taxation worldwide.
2. You should always keep in mind the current context of potentially varying tax treatment from country to country.
3. You should map the tax treatment of IP, transfer pricing, research and development (R&D) and other issues related to your digital business models from the very outset, as you first develop your strategies, and build in flexibility for the long term.

Overview

The end (of the beginning) is near. In November, G20 leaders are expected to put their final seal of approval on the output of the Organisation for Economic Co-operation and Development's two-year-old base erosion and profit shifting project (OECD BEPS Project). Will this momentous occasion signal a new world order — fit for a modern digital economy — or is it simply ushering in an open season for digital taxation?

The question spilled out at a high-level international tax conference recently, stirring debate. To put it in context, this broad new global BEPS framework for taxation — deliberately crafted to encompass digital economy business models — will profoundly change the international tax landscape across all industries. But the implementation of BEPS recommendations from one country to the next is already showing signs of strain — before the final recommendations have even been published.

Some countries have begun tearing pages from the draft BEPS playbook to institute their own domestic digital economy tax policies, re-interpreting the guidelines along the way. Some, it is argued, are simply going their own way.

Much is at stake for multinational companies and for the new digital business models that are redefining global markets and industries. But we are only at the dawning of digital economy taxation. For some time to come, digital taxation will continue to be a subject of acute uncertainty, with all the knock-on implications for business innovation and growth.

Early patterns emerge

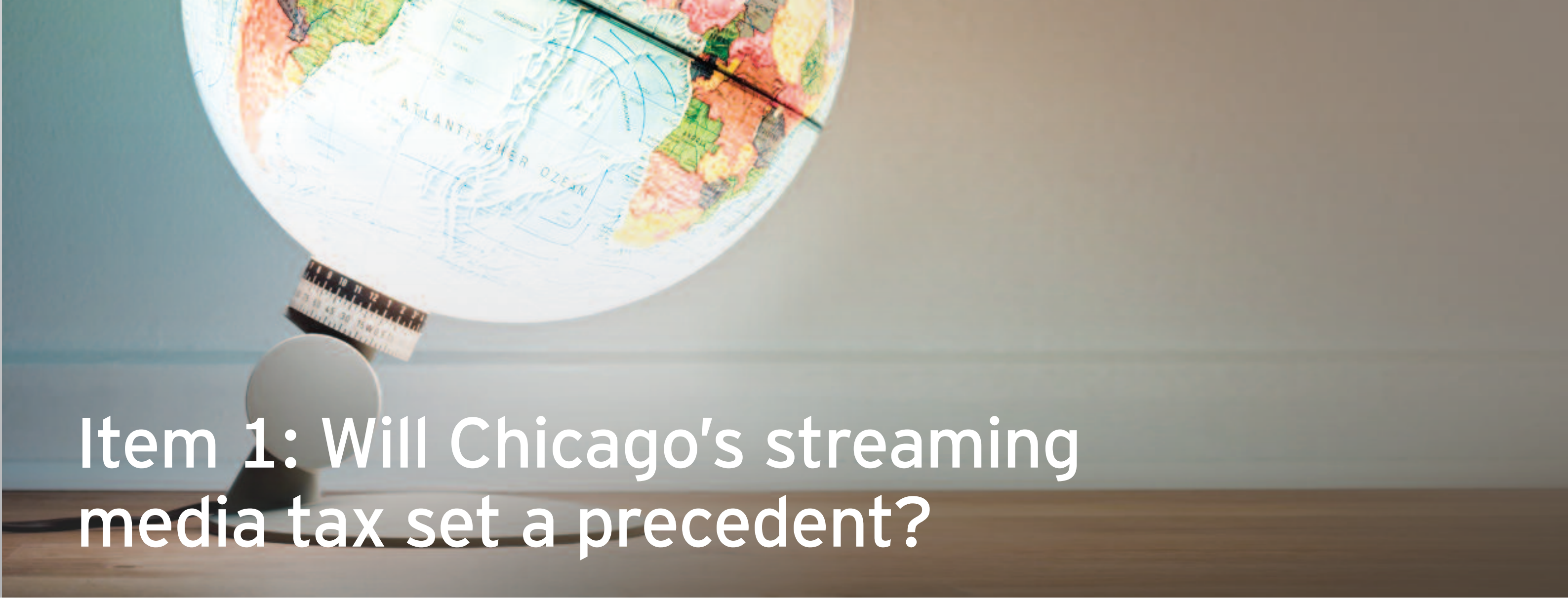
Indeed, patterns now emerging indicate ongoing uncertainty around some of the most challenging aspects of taxation in a global digital environment, notably those surrounding questions of value and location. In other words, there are sticking points regarding the direct taxation of income related to intellectual property (IP) and other intangibles, as well as associated revenue characterization and accounting for intragroup/intercompany transfer pricing, and regarding the creation of a permanent establishment (PE) in any given country.

These questions will continue to be deliberated nationally and internationally, even as the ink dries on the final BEPS report. But one thing is becoming clear, as we analyze in our new report,[1] any notion of zero-tax, "stateless income" is fading on the tax landscape, at the same time that companies consider more onshoring of IP ownership together with related development and commercialization to countries with the most beneficial, low-tax tax environments. Look for more about this in our next column.

Meanwhile, for tax authorities worldwide, the lower-hanging fruit of digital economy taxation appears to involve indirect taxes, especially value-added taxes/goods and services taxes (VAT/GST), and various and sundry withholdings. This open season on digital VAT — now being declared by many countries (and possibly migrating to cities and states) — presents a problem that is more or less an open secret: these are primarily end-user costs that multinational corporations have to decide whether to pass along to customers or somehow absorb.

Highlights and takeaways

Tax update	Technology impact	Ask yourself
Chicago imposes taxes on streaming media and on cloud computing.	Other states and cities in the US could follow suit.	Do you need to be prepared for similar taxes across the country?
Indirect digital tax changes are being proposed and implemented in countries around the world.	Digital VAT/GST proliferation emerges as the first clear pattern of new digital economy taxation.	Will you pass the VAT/GST costs along to your customers, bear the costs or share the costs?
German authorities focus on withholding taxes for royalties and licenses.	Increased audits add pressure atop legal uncertainties and complicated procedures.	Is there a more rational way to manage your risk and streamline the process? Will new guidance bring relief?
Saudis add "virtual service PE" to the tax lexicon.	Conventions sparing off-shore work from taxation are upended in Saudi Arabia and questioned at the UN Committee of Experts for Tax Cooperation.	Could the idea of declaring "virtual service PEs" catch on? What would it mean for your cross-border service contracts?
A US proposal would create an "innovation box" for IP, taxed at 10.15%.	An emerging trend toward on-shoring IP could spur more competition among nations by mechanisms alternatively known as "patent boxes" and "innovation boxes."	How could your company benefit from this US proposal? How does it compare with similar mechanisms in other countries?
Excerpts from an interview with Raffaele Russo, a leading OECD BEPS official.	OECD perspective is shared on current and future digital economy tax agenda work.	How long should you be prepared to keep digital taxation high on your board and C-suite agendas?
US Tax Court invalidates IRS ruling against a global tech company that did not share costs of stock-based compensation with its foreign subsidiary.	Court's decision could reflect more generally on transfer pricing arrangements and their taxation, for such activities as international R&D.	Could this ruling underpin a good faith challenge to the validity of existing cross-border cost-sharing requirements?



Item 1: Will Chicago's streaming media tax set a precedent?

With the rise of cloud-based software, streaming and other digital services, American cities and states are losing tax revenues on sales of DVDs, videogames and packaged software, according to *The Wall Street Journal* ("States Eye Taxes on Streaming Video and Cloud Computing," August 20, 2015).[2] The city of Chicago has stepped up to the challenge with new digital taxes. Will others follow?

Chicago's Department of Finance issued two rulings in June 2015, one pursuant to its amusement tax and one under its "personal property lease transaction tax." The net effect is that the city maintains it can impose an amusement tax on streaming entertainment and a transaction tax on software-as-a-service (SaaS), web-hosting, cloud computing and other services.

Both the amusement and transaction tax would be imposed at 9% on users in Chicago, with vendors required to collect the tax from each customer.

Questions abound

There are many questions about how these taxes would work in practice.

For instance, since the requirement to collect the amusement tax would fall solely on the providers of the amusement, there are questions about when that provider would have sufficient nexus with Chicago to be required to collect the tax. Regarding the transaction tax, one takeaway is that case-by-case analysis is required of both cloud service providers and users. For example, is the value in a given transaction tied to the use of SaaS to input, retrieve and modify data? If so, it may be taxable.

The amusement tax changes went into effect on September 1, 2015. A group of plaintiffs filed suit September 9 in Cook County Circuit Court challenging the expanded amusement tax. Chicago, due to reported pressure by the business community, has delayed implementation of the transaction tax changes until January 2016.

Considerations

Beyond Chicago, the prospect of similar taxes has been raised (and so far rejected) in the states of Alabama and Vermont, but accepted in Tennessee. With so many countries imposing digital VAT and consumption tax, the question now is whether other jurisdictions will do likewise. Companies should calculate the full potential scope of digital VAT across all jurisdictions in which they operate, as well as the potential business implications and possible cost of implementation.

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Item 2: Gauging the rising tide of indirect digital taxes

VAT/GST changes affecting cross-border digital transactions have been proposed and enacted in various countries throughout the year, including Australia, Belarus, the European Union, Israel, Japan, New Zealand, South Korea, Tanzania, Turkey and elsewhere.

Add in a tax on streaming media and cloud computing that was recently imposed by the City of Chicago (see Item 1) and what emerges is one of the first clear patterns of taxation for the global digital economy: indirect taxation trumping direct taxation.

That is, tax authorities are tending to impose VAT-like consumption taxes on digital services, ahead of tackling more complex digital income tax issues surrounding IP value, transfer pricing and PE.

Australia and New Zealand advance similar proposals

Australia and New Zealand recently released proposals to apply GST to "remote" services and low-value importations supplied by non-resident suppliers to domestic customers. The changes are not necessarily limited to digital services. In New Zealand, for example, remote insurance, financial, accounting and consulting services may also be covered.

Both countries have proposed making non-resident suppliers of low-value imported goods (such as those sold by e-commerce entities) register for GST and charge it to customers at the time of the sale. Specifically:

- Australian tax authorities have announced that the threshold below which GST does not have to be paid on goods imported into Australia will be reduced from the current level of AUD1,000 (USD700) to zero (i.e., the threshold will be eliminated). Hence, all goods imported into Australia after this time will be subject to GST. The mechanism for levying and collecting the GST remains unclear at present.
- The New Zealand Inland Revenue Department recently gathered public input on a proposal for overseas suppliers to register and account for GST when they supply electronic services to New Zealand-resident consumers. The proposal also foreshadows future changes to the threshold below which GST does not have to be paid on imported goods.

These are initial proposals and more details are expected to be published, such as whether these provisions would apply only to business-to-consumer (B2C) transactions or to both B2C and business-to-business (B2B) transactions. Australia is proposing changes from July 2017, and New Zealand is proposing them from 2016.

South Korean B2C VAT clarifies app store role

As of July 2015, South Korea will require non-resident companies to register for and charge 10% VAT on the supply of electronic services to Korean consumers. Online registration is required within 20 days of the start of business, with filings and payments due quarterly.

However, Foreign Service Providers delivering B2C services via app stores would not be required to register for VAT in South Korea, since the responsibility for charging VAT should rest with the app store. B2B services would also not require Foreign Service Providers to register for VAT, since VAT should be self-assessed by the customer for the first taxable period (July to December 2015), under a proposed clarification from the Ministry of Strategy and Finance. The full EY Global Tax Alert on the ruling is available here.[3]

Tanzanian VAT now covers electronic services

Tanzania has expanded its VAT law with a number of new rules — notably, requiring foreign businesses to collect and pay VAT on sales of electronically supplied services to Tanzanian consumers. Effective in July 2015, the new VAT Act is more generally intended to widen the Tanzanian tax base to cover most economic activities in the market, to improve revenue collection.

Non-registered entities cannot collect VAT in Tanzania. The 2014 VAT Act requires non-residents who carry on economic activity in mainland Tanzania (making taxable supplies) without having a fixed place in mainland Tanzania to appoint a VAT representative there.

Considerations

The tide of indirect, digital consumption taxes is rising, as also embodied in the OECD BEPS Project's "Guidelines on place of taxation for business-to-consumer supplies of services and intangibles." Any multinational enterprise employing digital business models needs to take note, particularly non-resident suppliers of B2C digital services. In addition to the VAT registration and compliance implications, companies should review whether their corporate structures and business models are fit for recent and upcoming VAT legislative changes, along with pricing strategies, profit and cash flow forecasting and contractual arrangements with third parties in their supply chains.

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Item 3: German authorities eye tax changes on cross-border licenses, royalties

German tax officials are expected to adjust the rules and procedures for withholding taxes on cross-border royalties and licenses for software-as-a-service and digital content into Germany. The timing is uncertain, and there has been no official word, but affected companies are hoping for clarification of considerable uncertainties surrounding their day-to-day activities.

These expectations have arisen as German tax authorities have also increased scrutiny on royalties and license fees, conducting audits that have led to significant additional taxes. Authorities' heightened interest mainly stems from a law change that went into effect in 2008 but where the effects have only recently started to be audited.

Overlapping provisions carry cost

Overlapping provisions raise the potential for double-taxation of royalties and license fees. On the one hand, findings by tax authorities could increase a taxpayer's trade tax (in Germany, the trade tax is based on taxable income as calculated for corporate income tax purposes with some modifications, such as a 6.25% add-back of royalty payments). On the other hand, such findings could lead to an assessment of withholding taxes if royalties are paid to non-residents because of a secondary liability of the entity paying the royalties.

It should be assumed therefore that in current German tax audits, cross-checks are made, so that if royalty payments are not fully deductible for trade tax purposes, the appropriate withholding tax treatment is applied, in cases where the royalty recipient is a non-resident.

Facing uncertainties

Under German law, a cross-border "payment in consideration for the temporary use of a right"/"payment for a transfer of know-how" should give rise to withholding taxes in a B2B situation. Based on the prevailing view, B2C transactions should not give rise to withholding taxes.

However, the classification of a payment is discussed controversially in many tax audits — i.e., whether a payment should give rise to withholding tax at all:

- Regarding software, the rule is broadly worded and does not necessarily allow for a distinction along the general guidelines of the OECD, according to which the mere use of a copyrighted article should be outside the scope of the definition of royalties so that royalties should only be given if a customer can actually exploit the copyright (i.e., by modifying the software, reproducing it, or publicly displaying it or distributing it). The only published view of the tax authorities on software payments is a very brief guidance released by the tax authority of Munich in 1998, broadly stating that payments for standardized software should not give rise to withholding taxes whereas payments for customized software should give rise to a withholding obligation. This view is challenging to apply in practice because there is no further guidance on what constitutes standardized vs. customized software and because it fails to address new activities and business models that have evolved over the past 17 years in a highly dynamic environment.
- Regarding the transfer of know-how/digital content, audit cases dealing with payments for financial market data by external service providers have come up often, for example, with tax auditors holding that the remuneration should be subject to withholding taxes. Unlike in the case of other findings, tax authorities have sometimes been unable/unwilling to negotiate and reach a compromise with taxpayers, since these cases are viewed as "high-profile" within the tax administration and potentially precedent-setting.

Navigating practical difficulties

In addition, procedural aspects of the German withholding tax rules often give German customers and their vendors a headache:

- Under German law, a customer can only refrain from levying withholding taxes (or withhold at a lower treaty/directive rate) if a transaction has been cleared with the Federal Tax Office (FTO) up front and the vendor has presented a valid withholding tax exemption certificate issued by the FTO before payment is made. Otherwise the customer of the non-resident vendor can be held secondarily liable for withholding taxes if a tax auditor successfully argues that a payment should give rise to withholding tax.
- Such withholding tax exemption certificates are specific to the contract under which the remuneration is paid and to the counter-party to the contract. Essentially, this means that a withholding tax exemption certificate has to be obtained for each contractual relationship that triggers withholding tax. Needless to say, in situations where a non-resident digital business has a large number of clients in Germany, obtaining withholding tax exemption certificates can be challenging from a purely practical perspective.

Reaction of the tax authorities

Prior to any new guidance, the FTO has started to take a quite liberal approach when issuing withholding tax exemption certificates. Even though this practice does not address the issue that a withholding tax exemption certificate is needed for each contractual relationship, it makes life easier for non-resident vendors that have a handful of customers or distributors in Germany requesting withholding tax exemption certificates.

Considerations

If possible from a practical perspective, obtaining withholding tax exemption certificates is certainly the best option for non-resident vendors as well as their customers. If withholding tax exemption certificates are not an option — e.g., because of the number of German customers — non-resident vendors should review whether they could take other measures to address the increasing uncertainty resulting from the classification of payments received from their German customers. In very exceptional cases, it may be possible to discuss with the FTO the possibility of a blanket withholding tax exemption certificate (typically any such agreement would require the consent of the Federal Ministry of Finance). If this is not an option, vendors may consider contractual agreements shifting the financial risk to their customers to limit their own exposure — or serving the German market through a German resident distribution entity and thus avoiding the withholding tax obligation on customer payments completely.

And, while it should be possible for the FTO to address these technical uncertainties by issuing guidance, the procedural difficulties may be harder to eliminate. In fact, it may require a change in law to fundamentally improve this process and make it easier to apply in cases where a non-resident has a large number of customers in Germany.

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Item 4: Saudi Arabia adds "virtual service PE" to the tax lexicon

In countries around the world, the taxation of foreign-supplied contract services does not generally extend to services performed outside of the country and generally requires a minimum level of presence in-country. Saudi Arabia's new "virtual service PE" provision overturns such conventions. A similar approach has been raised by the UN Committee of Experts for Tax Cooperation.[4]

Reinterpreting the "service PE"

Saudi Arabia's Department of Zakat and Income Tax (DZIT) has issued internal guidelines for processing requests for withholding tax exemptions and refunds made by non-residents having no legal registration, and consequently no PE, in the kingdom.

DZIT's guidelines provide a new interpretation of the "service PE" concept that takes into account only the duration of the contract itself, rather than the actual activities covered. In particular, DZIT introduces a "virtual service PE" concept, according to which a non-resident is deemed to have a PE in the kingdom if:

- A non-resident furnishes services to an entity in connection with the latter's activity in the kingdom
- The period during which such services are rendered, according to the contract, exceeds the threshold period under the applicable tax treaty (most often six months)

Challenging existing conventions

DZIT's approach does not consider the physical presence of employees or contractors of a non-resident service provider for establishing the nexus, although such a threshold condition is clearly provided by both OECD guidelines and UN Model Conventions and applied in many countries.

The practical consequence is that any work performed by a non-resident for a customer in the kingdom (over the six-month threshold) will create a service PE in the kingdom – even if activities are performed entirely offshore.

Related deliberations within the UN's tax committee appear to be leaning away from following the Saudi example. That said, representatives of some developing countries appear to support it.

Considerations

The wider potential international implications of the new "virtual service PE" should be monitored. The more immediate implication of these guidelines is that, in Saudi Arabia, the applicability of withholding exemptions or refunds with respect to cross-border services has become highly uncertain. The full EY Global Tax Alert on the matter is available here.[5]

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Item 5: US proposal would aid on-shoring of IP

A discussion draft now circulating in US Congress proposes a 10.15% effective rate of corporate tax on a portion of US corporate profits derived from qualifying IP, including patents, inventions, formulas, processes, designs, patterns and know-how (and from the sale of products produced using such IP), as well as other types of IP such as computer software.

The proposal to establish such an "innovation box" (known elsewhere as a "patent box") was introduced by Reps. Charles Boustany (R-LA) and Richard Neal (D-MA), both senior members of the House Ways and Means Committee.

In our introduction to this column, we alluded to the incipient trend toward the on-shoring of IP and its related assets, functions and risks to countries with the most beneficial, low-tax tax environments. It is in this context that the proposal would aim to encourage US multinationals to hold their IP assets in US entities, by providing for tax-free transfers of qualified IP from controlled foreign corporations to a US corporate shareholder.

The transfer would have to be pursuant to a contemporaneous written plan, filed with the IRS, describing the distribution of the intangible asset to the US shareholder. In most instances, the US shareholder would take a carryover basis in the transferred property.

Meanwhile, Italy implemented its patent box provisions in July, granting a 50% exemption (reduced to 30% for 2015 and 40% for 2016) from corporate income tax and local tax (generally levied at 27.5% and 3.9% respectively) on income derived from the licensing or the direct exploitation of qualifying IP. As such, it joins a growing group of nations with such beneficial IP regimes, including Ireland, Luxembourg, Switzerland and the UK.

Considerations

The proposal would provide an alternative to repatriation of offshore cash in a tax efficient manner, while giving the flexibility to keep the economic rights of IP within the US. Tech companies should compare the benefits of this proposal with those derived from similar regimes in other jurisdictions. US company executives should familiarize themselves with this proposal from the outset, track its progress and share their views on innovation boxes with legislators. The full EY Global Tax Alert on the proposal is available here.[6]

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Item 6: Excerpts from an interview with the OECD's Raffaele Russo

We opened this column by saying that the finalization of the OECD BEPS Project is only the end of the beginning — a sentiment well reflected in our recent interview with Raffaele Russo, the OECD's point man on BEPS. Here we excerpt his remarks, which focused on the Task Force on the Digital Economy that was created as part of the BEPS Action 1 work on the same subject.

The digital economy is the economy itself
"One of the first conclusions of the task force was that actually the digital economy is the economy itself. Even when you look at sectors of the economy that are considered to be more 'traditional,' like agriculture and health care, you see that basically everyone is being transformed by the digital economy. So it is not possible to ring-fence the digital economy for the purposes of tax policy. Any provisions that will be adopted in order to deal with the digitization of the economy should apply across the board."

Task force mandate
"Action 1 of the BEPS Project is unique, in a sense, because it does not only deal with the issues of base erosion and profit shifting. Action 1 also refers to issues related to VAT, and also requires an analysis of what we have called the broader tax challenges of the digital economy. And these challenges relate chiefly to nexus, data and revenue characterization for tax purposes."

Task force work
"We have identified two macro categories: BEPS issues and more systemic issues. And within the second category you have issues that relate to value-added tax or consumption tax, and issues that relate to direct taxation. Regarding consumption taxes, there is now full agreement that in relation to cross-border business-to-consumer transactions, VAT/GST should be collected in the market jurisdiction, meaning in the jurisdiction where the customer is located."

"The second subset is the one about the direct tax challenges, and in that context the task force has received a number of proposals from countries and stakeholders, ranging from a new nexus based upon a significant economic presence test, a withholding tax or a so-called excise tax to equalize the tax treatment of resident and non-resident taxpayers. The work that the task force has been doing so far has been on the analysis of the technical issues that these proposals raise, and possible solutions. And of course, there has been a lot of debate on how to determine the income that would be attributable to such a new nexus, including the issues of compatibility with international norms and bilateral tax treaties."

On the horizon

"There should be a more relaxed discussion about the world in which we live today and the world in which we will live in the next 10, 15 or 20 years. We need to have a conversation on what is the best way for countries to fund government expenses in an economy that is increasingly digitalized. I'm not only thinking about what we see today, but more [about] trends like 3D printing, which will completely change manufacturing – [and] the sharing economy, where basically individuals who are not in a paid-relationship with the enterprise, who are not employees or agents, effectively contribute to the value chain of these enterprises. When you square all that, I think you realize that there may be room for some deep thinking about the tax system of the new millennium."

Considerations

To Raffaele Russo's comments, we would add that even after the OECD BEPS Project clears important milestones in the coming weeks, domestic legislation and bilateral treaty changes are yet to come, and the OECD still has another year to deliver a multilateral instrument to aid in the latter. So, the BEPS Project is a near-term permanent fixture that will have to be accounted for across digital business strategies and operations. Corporate tax teams are well aware of this, and they should be part of any significant international business decision going forward.

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Item 7: US Tax Court invalidates IRS ruling on cost-sharing of stock-based compensation

In July, the US Tax Court issued a blow to the IRS by striking down a 2003 regulation that required taxpayers to share stock based compensation expenses among participants of a qualified cost sharing arrangement (QCSA). The opinion, which was reviewed by the full court, is a significant victory for taxpayers and in particular technology companies, who routinely use QCSAs to develop IP and facilitate expansion into foreign markets.

The issue addressed in this case was whether stock based compensation expenses must be included in the pool of intangible development costs (IDCs) that get shared among participants to a QCSA. QCSAs are agreements between related parties (e.g., a parent company and its foreign subsidiary) to share the costs of developing intangibles in proportion to the benefits the participants realize in the commercial exploitation of those assets. (For example, each participant could be allocated a share of the total IDCs based on the participant's customer revenue in its territory relative to worldwide revenue.)

QCSAs provide taxpayers, and in particular technology companies, with several benefits. For example, under US tax rules, cost sharing participants can share IDCs at cost, rather than price the individual R&D services each participant contributes to the arrangement. Participants also get royalty-free exploitation rights associated with any intangibles developed under the arrangement, eliminating the need to price and defend various cross licenses. For technology companies, who operate in an era of "instant obsolescence" and as a result invest heavily in R&D in order to stay relevant in a highly competitive market-place, the benefits associated with a QCSA can have a significant impact on a firm's operating results.

The IRS has long argued that the pool of IDCs to be shared in a QCSA should include the cost of any equity compensation granted to personnel engaged in IP development activities. The IRS position is premised on two theories:

1. That stock based compensation and cash compensation are equivalent economic costs on a dollar for dollar basis; and as a result, the two types of compensation (stock and cash) should have similar treatment within a QCSA. (Note that the IRS is not the only regulatory agency to hold this view). The Financial Accounting Standards Board now requires publicly traded companies to expense to cost of equity grants in their financial statements. Moreover, the OECD has issued guidance indicating that stock based compensation expenses ought to be considered for transfer pricing purposes, including within a cost sharing context.

2. That third parties share stock based compensation costs within the context of cost sharing; and as a result, related parties should also share these expenses to achieve an arm's length outcome. (The arm's length principle is the international standard for which related party pricing is judged for tax purposes.)

The US tax regulations addressed in this particular case were issued by the IRS in 2003. These regulations specifically mandate the inclusion of stock based compensation in the pool of IDCs to be shared by cost sharing participants. Moreover, the regulations state that a QCSA will only produce an arm's length result if stock based compensation costs are treated as IDCs and shared among the participants.

The 2003 regulations that mandate the inclusion of stock based compensation in IDCs were initially proposed by the IRS and Treasury Department in July 2002. As part of the rulemaking process, commentators, including many high profile technology companies, were given the opportunity to provide input in a public hearing on the proposed rules. In November 2002, commentators officially responded. Not surprising, the validity of the rules was uniformly challenged by taxpayers, practitioners and academics. Commentators at the November 2002 hearing argued that stock based compensation does not represent a real economic cost, nor does the decision to grant equity compensation to employees change a company's operating results or factor into its pricing decisions. Commentators also argued that unrelated parties would never agree to share or reimburse equity compensation costs because these costs are speculative and outside the control of the parties. And finally, commentators provided ample evidence of third party cost sharing arrangements that did not take into account stock based compensation. The IRS and Treasury did not provide, at any point during the rulemaking process, any evidence

to support the claim that unrelated parties share or take into account stock based compensation expenses. In spite of the evidence presented by commentators at the hearing, Treasury issued the final rule in August of 2003, explicitly requiring parties to QCSAs to share stock based compensation expenses.

Ironically, prior to the start of the 2003 rulemaking process, the IRS litigated a similar issue involving stock based compensation expenses under the predecessor regulations that were issued in 1995. The 1995 regulations were silent on the treatment of stock based compensation within a QCSA. Instead, the regulations directed participants to share "all costs" related to the development of intangibles. The taxpayer argued in this particular case that the arm's length standard required controlled parties to share only those costs that uncontrolled parties would share. And the taxpayer presented evidence that third parties do not share stock based compensation costs in a cost sharing or other context. The IRS argued that the specific "all cost" requirement meant all costs, including equity compensation costs, irrespective of whether one can find reliable evidence of third party cost sharing behavior. The taxpayer ultimately won this case, first in US Tax Court and later in the Court of Appeals for the Ninth Circuit. Both courts found the taxpayer's interpretation of the arm's length more reasonable.

Court's findings

In the current case, the Tax Court considered whether the final 2003 regulation mandating inclusion of stock options in the IDC pool was valid. The court's assessment considered whether the regulation satisfied the "reasoned decision-making standard" as required when issuing legislative rules under the Administrative Procedures Act. In doing so, the court addressed four arguments that were advanced by the taxpayer:

1. The final rule lacks a basis in fact
2. Treasury failed to rationally connect the choice it made with the facts it found
3. Treasury failed to respond to significant comments put forth by taxpayers, practitioners and academics during the rulemaking process
4. The final rule is contrary to the evidence before Treasury

The Tax Court found in favor of the taxpayer on each of these arguments and concluded that Treasury and IRS failed to engage in "reasoned decision-making" during the rulemaking process, essentially turning a blind eye to the overwhelming evidence presented to it. Moreover, Treasury and IRS failed to engage in any fact finding or analysis in support of its own position, arguing instead that it was not obligated to justify its position. As a result, the US Tax Court found that the final 2003 rule regarding stock based compensation is inconsistent with the arm's length standard.

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Considerations

While the 2003 final regulation is technically still valid, the court's decision represents a significant win for all taxpayers, but most importantly for technology companies. As noted above, technology companies routinely use QCSAs to develop intangibles and facilitate expansion into foreign markets. Moreover, the technology industry, more so than any other industry, has always favored the use of equity compensation to remunerate its personnel. Equity compensation has become so prevalent for technology companies that some analysts believe tech companies pay out, on average, over half of free cash flow in the form of equity grants, the cost of which could in the long term (depending on how the IRS and Treasury ultimately respond to the court's decision) escape the pool of IDCs to be shared in a QCSA.

The opinion should be sufficient at this time to establish both a good faith challenge to the validity of the regulation and a realistic possibility of the position being sustained on its merits. If a taxpayer wishes to take a position on a federal tax return that is consistent with the court's opinion, that taxpayer must disclose the position on a properly completed Form 8275-R attached to the return in order to avoid a penalty. The case is not yet final, however, and the IRS may appeal this particular holding, or the IRS may provide direction to taxpayers about how to proceed in light of the decision. The full EY Global Tax Alert on the court's ruling is available here.[7]

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Note: the views expressed in this column are those of the authors and do not necessarily reflect the views of the global EY organization or its member firms. Check with your local EY tax advisor for the latest information regarding these rapidly developing topics.

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