ANNUAL NEW ENGLAND CORPORATE TAX CONFERENCE

December 1, 2016
Today’s Agenda

- 8:00-8:30: Breakfast/Networking
- 8:30-9:20: Federal Tax Policy and Legislative Update (Kevin Anderson)
- 9:20-10:10: Compensation & Benefits/Payroll (Alex Lifson and Jae Erdekian)
- 10:10-11:00: SALT/Sales Tax (Matthew Dyment and Jim Bowden)
- 11:00-11:50: International Tax (Fred Corso)
- 11:50-12:20: Lunch
- 12:20-1:10: Taxable Acquisition Structures Involving S Corporations (Greg Falk)
- 1:10-2:00: ASC 740 (Bill Connolly and Daniel Newton)
FEDERAL TAX POLICY AND LEGISLATIVE UPDATE

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AGENDA

- Recently Enacted Tax Legislation
- Other Legislative Activity
- Other Updates from IRS and Treasury
- Prospects for Fundamental Tax Reform
- Presidential-Elect’s Tax Proposals
- Questions and Answers
RECENTLY ENACTED LEGISLATION
PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015 (“PATH ACT”)

• Pub. L. No. 114-113, Div. Q, signed December 18, 2015:
  – Extended most expired tax provisions retroactively to the beginning of 2015
  – Made many provisions permanent
  – Phased out other provisions

• No effort to offset costs of decreased revenues
  – Five-year revenue loss of $396 billion, FY 2016 through 2020
  – Second five-year revenue loss of $226 billion, FY 2021 through 2016
  – Total ten-year revenue loss of $622 billion
Projected Revenue Loss

$ (Millions)

• Principal features of the PATH Act for R&D credits:
  — Credit is expanded and made permanent
  — Enhanced utilization for “eligible small businesses,” giving the credit “specified credit” status so as to offset both regular tax and AMT
  — Payroll tax offsets for “qualified small businesses,” which are likely to have little or no income tax liability

• Key definitions and limitations:
  — “Eligible small business” has average annual gross receipts not exceeding $50 million for three preceding taxable years
  — “Qualified small business” may offset up to $250,000 of payroll tax liabilities in each year for up to five years
PATH ACT/BONUS DEPRECIATION

• Brief history of bonus depreciation provisions:
  – Originally enacted at 30% for property acquired and placed in service after September 10, 2001
  – Increased to 50% for property acquired and placed in service after May 5, 2003
  – Allowed to expire effective January 1, 2005 (with certain exceptions)
  – Reinstated at 50% for property acquired and placed in service after December 31, 2007, temporarily
  – Increased to 100% for property placed in service from September 9, 2010, through December 31, 2011
  – Further extended at 50% for property placed in service after 2011 and through December 31, 2014
PATH ACT/BONUS DEPRECIATION (CONT’D)

- PATH Act further temporary extensions:
  - 50%, for property placed in service through 2017
  - 40%, for property placed in service in 2018
  - 30%, for property placed in service in 2019
  - Retained a complex provision to make certain AMT credits refundable if the taxpayer forgoes bonus depreciation
First-year expensing increased limitations made permanent:
- Annual limitation is $500,000 in fixed assets acquired and placed in service
- Annual limitation is reduced dollar-for-dollar for total fixed asset additions in excess of $2 million for the year
- Both amounts to be indexed for inflation beginning in 2016

15-year recovery period made permanent for:
- Qualified leasehold improvements
- Qualified restaurant property
- Qualified retail improvements
PATH ACT/OTHER BUSINESS PROVISIONS

• International tax provisions:
  – Active financing exception from subpart F provisions (permanent)
  – Subpart F “look-through rule” for controlled foreign corporations (through 2019)

• S corporation provisions made permanent:
  – Five-year recognition period for section 1374 built-in gains tax
  – Favorable stock basis adjustments for charitable contributions of appreciated property

• Affordable Care Act provisions temporarily suspended:
  – Medical devices excise tax suspended for 2016 and 2017
  – “Cadillac” tax on high-cost health plans delayed for two years (to 2020)
  – Health insurance provider fee suspended for 2017
PATH ACT/OTHER BUSINESS PROVISIONS (CONT’D)

- Section 1202 exclusion for small business stock made permanent at 100%
- Extensions through 2019:
  - Work opportunity tax credit
  - New markets tax credit
- Variety of other business incentive provisions extended only for two years, through 2016
- Variety of energy incentives extended for varying periods, through 2019
PATH ACT/INDIVIDUAL PROVISIONS

• Variety of personal/individual tax provisions made permanent:
  – Deduction for state sales and use taxes in lieu of state and local income taxes
  – American Opportunity Tax Credit
  – Increased child tax credit amounts
  – Above-the-line deduction for up to $250 of out-of-pocket expenses of elementary and secondary school teachers
  – Earned income credit enhancements
  – Transit benefits parity
  – Favorable treatment of charitable distributions from IRAs
PATH ACT/INDIVIDUAL PROVISIONS

- Variety of personal tax provisions extended for two years (through 2016):
  - Above-the-line deduction for qualified tuition and fees for post-secondary education
  - Limited exclusion for income from cancellation of mortgage debt
  - Deduction of mortgage insurance premiums as home mortgage interest
OTHER ENACTED TAX LEGISLATION

• Pub. L. No. 114-94, signed December 4, 2015:
  – Fixing America’s Surface Transportation ("FAST") Act
• Non-highway revenue provision; Act Section 32102 directs the IRS to:
  – Enter into qualified tax collection contracts to collect outstanding inactive tax receivables;
  – Establish a program to hire, train, and employ special compliance personnel to collect taxes using the automated collection system; and
  – Provide a progress report to congressional committees.
• See IR-2016-125 for recent implementation.
OTHER ENACTED TAX LEGISLATION (CONT’D)

• Pub. L. No. 114-239, signed October 7, 2016:
  – United States Appreciation for Olympians and Paralympians Act of 2016

• Key provisions:
  – Exempts from income tax the value of medals and prize money received for competing in Olympic Games or Paralympic Games
  – Not available to individuals with adjusted gross income exceeding $1 million for the taxable year
  – Effective for prizes and awards received after December 31, 2015
OTHER LEGISLATIVE ACTIVITY
THE APPROPRIATIONS CALENDAR

- Federal Government’s fiscal year ends on September 30
- Pub. L. No. 114-223, signed September 29, 2016:
  - Continues appropriations for all government operations at prior levels, with approximately ½% across-the-board reductions
  - Expires December 9, 2016
- Principal “hot button” spending issues
  - Zika funding
  - Emergency relief for Louisiana flooding
  - Water resources (Flint, Michigan, and elsewhere)
CONGRESS AND THE IRS/PROPOSED LEGISLATION

• H.R. 3724
  – Prevents the IRS from rehiring any individual who was previously discharged due to misconduct

• H.R. 4890
  – Prevents the IRS from paying any bonuses to employees until it has adopted a comprehensive customer service strategy

• H.R. 1206
  – Prevents the IRS from hiring any employee until the Secretary of the Treasury certifies that no employee has seriously delinquent tax debt
CONGRESS AND THE IRS/PROPOSED LEGISLATION (CONT’D)

- H.R. 5053, Preventing IRS Abuse and Protecting Free Speech Act
  - Prevents the IRS from requiring a section 501(c) organization to provide any donor information, with two limited exceptions
- H.R. 4885, IRS Oversight While Eliminating Spending (OWES) Act of 2016
  - Requires all IRS user fees to be deposited into the general fund of the Treasury
OTHER CHALLENGES FOR THE IRS

• Continued budget pressures
  – Agency annual appropriations reduced by $900 million since 2010
  – Total headcount down 17,000 since 2010, 2,000 in last year alone
  – Audit coverage at historic lows

• Increasing demands from new tax legislation

• Section 501(c)(4) investigations

• Glimmers of hope
  – Following supplemental appropriation of $290 million specifically for taxpayer service, identity theft, and cybersecurity, hired 1,000 employees to staff phone lines
  – Near-term plans to hire 600 to 700 employees in enforcement areas
STILL ANOTHER CHALLENGE

- Rep. Jason Chaffetz (R-Utah) has introduced a resolution to impeach Commissioner John Koskinen
- Joined by 18 House Oversight Committee members, it alleges that the Commissioner:
  - Engaged in a pattern of conduct that is incompatible with his duties as an Officer of the United States;
  - Engaged in a pattern of deception that demonstrates his unfitness to serve as Commissioner;
  - Has acted in a manner inconsistent with the trust and confidence placed in him as an Officer of the United States; and
  - Has failed to act with competence and forthrightness in overseeing the investigation into IRS targeting of Americans.
- May 24 House Judiciary Committee hearings
OTHER UPDATES FROM IRS AND TREASURY
SIGNIFICANT REGULATORY DEVELOPMENTS

• Section 385 regulations
  – Proposed April 4; finalized (mostly) October 13
  – Imposes new documentation requirements on related-party debt
  – May recharacterize significant related-party debt as equity

• Proposed Section 2704 regulations
  – Would significantly reduce the use of valuation discounts in making gifts of closely-held business interests
  – Public hearing scheduled for December 1; finalized before January 20, 2017?
PROSPECTS FOR FUNDAMENTAL TAX REFORM
FACTORS MOTIVATING TAX REFORM

- Nominal corporate tax rates (highest or nearly highest)
- International competitiveness
- Treatment of foreign investment by U.S. businesses
  - Deferral (generally) if in foreign subsidiaries
  - Subpart F income
  - Repatriation of earnings
  - Reinvestment in United States property
  - Foreign tax credits
  - Transfer pricing (arm’s length) standards
FACTORS MOTIVATING TAX REFORM (CONT’D)

• Complexity of the Internal Revenue Code
• Frequent changes to tax provisions
• Continued reliance on temporary/expiring tax provisions
• Compliance burdens resulting from complexity
• Use of Internal Revenue Code to achieve certain social and economic goals (substitute for grant programs)
  – Retirement and investment incentives
  – Treatment of health care benefits, including Affordable Care Act provisions
  – Education incentives
  – Adoption incentives/subsidies
  – Capital gains incentives
GOP “BETTER WAY” TAX REFORM PROPOSALS

• 1986-style tax reform consisting of:
  – Reduced tax rates
  – Broaden the base by eliminating or reducing a wide variety of tax benefits for business and individual taxpayers

• Overview of tax rates and proposals:
  – Top corporate tax rate of 20% (compared with current 35%)
  – Individual split top rates of 25% and 33% (compared with current 39.6%)
  – Eliminate need for itemized deductions for approximately 95% of individual taxpayers
  – Significant reform of international taxation
THE “DYNAMIC SCORING” DEBATE

• “Static” vs. “dynamic” estimates of changes in revenues:
  – A “static” estimate takes expected behavioral changes into account but not macroeconomic changes
  – A “dynamic” estimate takes expected macroeconomic changes into account, including growth in jobs and in the economy (GDP)

• The “Better Way” blueprint is said to be revenue neutral using dynamic scoring
PRINCIPAL BUSINESS/CORPORATE TAX PROPOSALS

- Reduce corporate tax rate to 20%
- Repeal section 199 (domestic production) deduction
- Full expensing of capital improvements
- No current deduction for “net interest expense,” but excess may be carried forward indefinitely
- Modify (but retain) the research credit
- Permit net operating losses to be carried forward indefinitely
PRINCIPAL BUSINESS/CORPORATE TAX PROPOSALS (CONT’D)

- Retain last-in, first-out (“LIFO”) inventory methods
- Repeal corporate alternative minimum tax
- Provide for lower rate of tax on business income taxed to individuals, e.g., sole proprietorships, S corporations, and partnerships
PRINCIPAL INTERNATIONAL TAX PROPOSALS

• Switch from world-wide to territorial system:
  – Border adjustment system taxes sales to United States customers, whether the taxpayer is foreign or domestic
  – Conversely, the system exempts sales to foreign customers are exempt, whether the taxpayer is foreign or domestic
• Represents move toward consumption tax
• Allows significant simplification of subpart F rules
• The “toll tax” (payable over eight years) has two parts:
  – An 8.75% tax on accumulated foreign earnings held in cash or cash equivalents; and
  – A 3.5% tax on other accumulated foreign earnings.
PRINCIPAL FEATURES OF INDIVIDUAL TAX PROPOSALS

• Reduce tax rates across the board
  – Maximum tax rate of 33% (down from 39.6%)
  – Lower tax rates for business income taxable at individual rates
• Repeal individual alternative minimum tax
• Permit a 50% deduction for net capital gains, dividends, and interest income
• Larger standard deduction and enhanced child and dependent tax credit—replaces five current provisions
• Continue earned income tax credit
PRINCIPAL FEATURES OF INDIVIDUAL TAX PROPOSALS (CONT’D)

- Simplify benefits for higher education
- Retention/modification of other tax benefits:
  - Mortgage interest deduction
  - Unspecified incentives for charitable giving
  - Tax incentives for savings and retirement
- Repeal other exemptions, deductions, and credits
- Repeal the estate tax
### Individual Income Tax Rates for 2016

#### Married Filing Jointly or Qualifying Widow(er)

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax will be:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $18,550</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $18,550 but not over $75,300</td>
<td>$1,855 plus 15% of the excess over $18,550</td>
</tr>
<tr>
<td>Over $75,300 but not over $151,900</td>
<td>$10,367.50 plus 25% of the excess over $75,300</td>
</tr>
<tr>
<td>Over $151,900 but not over $231,450</td>
<td>$29,517.50 plus 28% of the excess over $151,900</td>
</tr>
<tr>
<td>Over $231,450 but not over $413,350</td>
<td>$51,791.50 plus 33% of the excess over $231,450</td>
</tr>
<tr>
<td>Over $413,350 but not over $466,950</td>
<td>$111,818.50 plus 35% of the excess over $413,350</td>
</tr>
<tr>
<td>Over $466,950</td>
<td>$130,578.50 plus 39.6% of the excess over $466,950</td>
</tr>
</tbody>
</table>
## INDIVIDUAL TAX RATE COMPARISONS

<table>
<thead>
<tr>
<th>Current Law</th>
<th>The GOP “Better Way”</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>0%/12%*</td>
</tr>
<tr>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>28%</td>
<td></td>
</tr>
<tr>
<td>33%</td>
<td>25% on “small business income”</td>
</tr>
<tr>
<td>35%</td>
<td>33% on other income</td>
</tr>
<tr>
<td>39.6%</td>
<td></td>
</tr>
</tbody>
</table>

*Treats increased standard deduction as an effective 0% tax rate*
LARGEST TAX EXPENDITURES, 2014-2018

Soc. Sec. benefits $209
Child tax credits $286
State and local tax $316
Medicare benefits $350
EITC $353
Mortgage interest $405
CFC deferral $421
Dividends/LTGC $633
Retirement savings $805
Healthcare $1,245

Source: Joint Committee on Taxation

Dollar amounts in billions
PRESIDENT-ELECT’S TAX PROPOSALS
## COMPOSITION OF THE HOUSE—2017

<table>
<thead>
<tr>
<th>Party Affiliation</th>
<th>Number</th>
<th>Election Results</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republicans</td>
<td>246</td>
<td>(8)</td>
<td>238</td>
</tr>
<tr>
<td>Democrats</td>
<td>186</td>
<td>7</td>
<td>193</td>
</tr>
<tr>
<td>Vacancies</td>
<td>3</td>
<td>(3)</td>
<td>-</td>
</tr>
<tr>
<td>Undecided</td>
<td>4</td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Totals</td>
<td>435</td>
<td></td>
<td>435</td>
</tr>
</tbody>
</table>
## COMPOSITION OF THE SENATE—2017

<table>
<thead>
<tr>
<th>Party Affiliation</th>
<th>Continuing</th>
<th>Term Expiring</th>
<th>Election Results</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republican</td>
<td>30</td>
<td>24</td>
<td>(3)</td>
<td>51</td>
</tr>
<tr>
<td>Democrat</td>
<td>34</td>
<td>10</td>
<td>2</td>
<td>46</td>
</tr>
<tr>
<td>Independent*</td>
<td>2</td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Undecided</td>
<td></td>
<td></td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>66</strong></td>
<td><strong>34</strong></td>
<td></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

*Both senators caucus with Democrats.*
# PROJECTED EFFECTS ON FEDERAL DEBT

<table>
<thead>
<tr>
<th>Category</th>
<th>Trump</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unfunded policies</td>
<td>$100</td>
</tr>
<tr>
<td>Tax cut</td>
<td>4,500</td>
</tr>
<tr>
<td>Interest on debt</td>
<td>700</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$5,300</strong></td>
</tr>
</tbody>
</table>

All numbers are in billions of dollars.
PROJECTED EFFECTS ON FEDERAL DEBT

CLINTON

Savings/ New taxes
Spending/ tax cuts

$2.1T
$2.25T

$200B new debt

TRUMP

Savings/ New taxes
Spending/ tax cuts

$1.5T
$6.8T

$5.3T new debt

Source: The Washington Post
Note: Numbers may not add to total due to rounding.
“DISTRIBUTIONAL” EFFECTS OF TAX PLANS

Opposite Directions
Donald Trump and Hillary Clinton split sharply on whether the tax burden of the highest-income U.S. households should increase or decrease. Here’s how their tax plans would affect the amount of income remaining after taxes.

Percentage change in after-tax income
by candidate’s tax plan and income level (2017)

<table>
<thead>
<tr>
<th>Income Level</th>
<th>Trump</th>
<th>Clinton</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 0.1%</td>
<td>+14.2%</td>
<td>-10.8%</td>
</tr>
<tr>
<td>Top 1%</td>
<td>13.5%</td>
<td>-7.4%</td>
</tr>
<tr>
<td>Top 20%</td>
<td>6.6%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>Second 20%</td>
<td>2.2%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Middle 20%</td>
<td>1.8%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Fourth 20%</td>
<td>1.2%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Bottom 20%</td>
<td>0.8%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

Source: Tax Policy Center
THE WALL STREET JOURNAL.
CORPORATE TAX PROPOSALS—TRUMP

- Reduce corporate tax rate from 35% to 15%:
  - Lower rate presumably applies to business income otherwise taxed at individual rates
  - Deemed repatriation of foreign earnings at 10% tax rate
- Retains research credit; repeals most other corporate tax expenditures
- Potential (elective) full expensing of improvements by manufacturers:
  - Taxpayer must give up deduction for interest
  - Otherwise, may keep depreciation and interest expense deductions
INDIVIDUAL TAX PROPOSALS—TRUMP

- Across-the-board rate reduction:
  - Similar to GOP “Better Way” plan, with rates of 12%, 25%, and 33%
  - Generally retains structure of capital gains tax rates (0%, 15%, and 20%)
  - Presumably offers 15% maximum tax rate on business income available to corporations
- Limit overall deductions to $100,000 for single filers and $200,000 for married couples
- Standard deduction increased to $15,000 for single filers and $30,000 for married couples
INDIVIDUAL TAX PROPOSALS—TRUMP (CONT’D)

- Replace deduction for personal exemptions with child-care tax benefits
- Eliminate the alternative minimum tax
- Tax carried interest as ordinary income
- Repeal estate tax
  - In exchange, carryover basis at death will apply to estates valued over $10 million
- Disallow contributions of appreciated assets to private charities established by decedent or related persons
QUESTIONS & ANSWERS

For Additional Questions Please Contact:

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COMPENSATION & BENEFITS UPDATE

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ALIFSON@BDO.COM
TODAY’S AGENDA

- Stock-Based Compensation Accounting Changes
- 83(b) elections
- Section 162(m) Limitation
- Private Company Liquidity Transactions
- Profits Interests
- Deferred Compensation - 409A and Special FICA Rules
- Bonus Accruals
- Affordable Care Act Reporting
ACCOUNTING STANDARDS UPDATE (ASU)
IMPROVEMENTS TO EMPLOYEE SHARE-BASED PAYMENT ACCOUNTING

Released on March 30, 2016
8 topics for “Simplification Initiative”

• **Effective Dates:**
  – Public Entities - Annual Periods beginning after December 15, 2016
  – All Other Entities - Annual Periods beginning after December 15, 2017
  – Early Adoption Is Permitted

• **Amends ASC Subtopics:**
  – 718, 260, 740, 805, 230, 323
ACCOUNTING STANDARDS UPDATE (ASU)
IMPROVEMENTS TO EMPLOYEE SHARE-BASED PAYMENT ACCOUNTING

• Accounting For Income Taxes - Windfalls & Shortfalls
  – APIC Pool is eliminated
  – Windfalls and shortfalls recognized through tax expense in Income Statement
  – Get ready for more volatility in earnings, EPS
  – Will amend ASC 740-270 for intra-period allocations to not be “ordinary income”, so not forecasted for annual effective rate

• Recognition of Excess Tax Benefits
  – Recognize tax benefits without regard to realization
  – Immediate recognition of windfall NOLs (through tax expense, no more off balance sheet accounting)
 Accountancy Standards Update (ASU)


**Statement of Cash Flows**
- **Excess tax benefits** are classified in Operating Activities
  - No more reclassification
- Change from PASU to allow prospective adoption

**Forfeitures**
- One time election to either:
  - Continue to apply current guidance, or
  - Account for forfeitures when they occur (i.e. reversal in period forfeited)

**Minimum Statutory Tax Withholding**
- Now: Maximum statutory tax rates in the employees’ applicable jurisdiction
- Based on rates required by the relevant tax authority
ACCOUNTING STANDARDS UPDATE (ASU)
IMPROVEMENTS TO EMPLOYEE SHARE-BASED PAYMENT ACCOUNTING

• Expected Term for Private Companies
  – Same as SAB 110 (midpoint between vest date and contractual term), without meeting 110’s requirements (plain vanilla, at the money, etc.)
  – Can be applied anytime
  – Can be used for liability awards
  – Doesn’t apply to market conditions

• Intrinsic Value for Private Companies
  – Allows a one time election (same as when FAS 123R was adopted)
  – Switch to intrinsic value for all liability awards
83(B) ELECTION FILINGS

- Proposed Regulation REG-135524-14
  - 83(b) elections would no longer be required to be filed with individual tax returns
  - Proposed Effective Date January 1, 2016
  - May be relied on for elections made on or after January 1, 2015.
IRC SECTION 162(M)

- Section 162(m) limits the corporate tax deduction for annual compensation paid to a covered employee to $1 million.
- The first $1 million can be deducted; any excess over $1 million is disallowed.
  - This is the basic rule.
  - However, there are exceptions (discussed on the next few slides).
  - If the compensation meets these exceptions, the amount in excess of $1M is also deductible.
- Applies to all publicly-held corporations
  - Equity securities required to be registered with the SEC
162(M) - COVERED EMPLOYEES

- Only applies to “Covered Employees”
  - Chief Executive Officer; and
  - The three most highly compensated officers (other than the chief executive officer and chief financial officer) whose compensation is required to be reported in the Company’s Proxy Statement for the fiscal year.
    - The PFO/CFO is excluded from the 162(m) limitation due to automatic inclusion in the proxy.
IRC SECTION 162(M) - EXCEPTIONS

- Performance-Based Pay Arrangements
- Commissions
- Payments to Tax-Qualified Retirement Plans
- Amounts excludable from Gross Income (e.g. employer-provided health benefits)
- Compensation payable under a written contract- effective since February 17, 1993
- Grandfathered pay arrangement for new IPOs
Smaller Reporting Companies have different SEC disclosure rules vs. large companies.

The required disclosure is:
- PEO/CEO
- the two most highly compensated executive officers other than the PEO who were serving as executive officers at the end of the last completed fiscal year.

The CCA provides that the PFO/CFO is a covered employee if included in the proxy as a result of being in the group of two most highly compensated executive officers.
SECTION 162(M) - ASC 740 ISSUES

• Ordering of 162(m) Deductibility
  – 3 Choices:
    o Equity First
    o Equity Last
    o Pro-Rata
  – Project future income and timing of equity deduction
  – DTA for deductible portion only
  – Tracking issues...
SECTION 162(M)  
2015 FINAL REGULATION CHANGES

• Newly IPO Companies have a transition rule
  — Stock options, SARs, Restricted Stock granted shortly after IPO are exempt from limitation
• RSUs are not included in transition rules if granted on or after April 1, 2015.
• RSUs granted before April 1, 2015 are fully grandfathered and exempt
PRIVATE COMPANY LIQUIDITY TRANSACTIONS

• VC/Accredited Investors purchase founders/employees common stock
  Purchase Price > 409A Valuation
    – usually tied to preferred financing round/price
• Questions Abound:
  – Is the excess over 409A price a bonus?
  – Subject to withholding tax by company?
  – Does this result in an accounting Compensation Charge?
  – Should an ASC 450 (FAS 5) reserve by required, if material?
  – Does this change the 409A valuation after the transaction?
PROFITS INTERESTS

• An interest in a partnership, LLP, or LLC (taxed as partnership)
• Only entitles the holder to future profits and appreciation of the partnership’s assets (versus a capital interest which entitles holder to current and future interests)
• Subject to ASC 718, unless the substance of the instrument is that of a performance bonus or profit sharing arrangement. If so, it is subject to ASC 710. This determination may be highly subjective.
• Some tax and valuation matters arise...
PROFITS INTERESTS

- Non-taxable if certain conditions met:
  - Grant date liquidation value = zero
  - Must hold for 2 years
  - Cannot be substantially certain income stream (i.e., from investment income)
  - Must treat recipient as a partner from grant date forward, irrespective of vesting conditions
  - Partnership cannot claim a tax deduction
  - See Rev. Procs. 97-23 & 2001-43 for more info
  - ASC 718 - results in compensation expense
  - \( FV = FMV \) (not liquidation value)
  - May require option pricing model
  - No tax deduction, so no DTA
  - Equity vs. Liability - analysis must be performed
TEMPORARY REGULATIONS SECTION 301.7701-2T

Issued May 3, 2016
Clarification of Existing Rules
Partners in Top Tier Partnerships Not Employees of Second Tier Partnership-Disregarded Entity

- Implications for:
  - FICA Tax
  - Cafeteria Plans
  - Health Insurance Benefits
  - Qualified Plans

- Effective on Later of
  - August 1, 2016, or
  - First day of latest starting plan year following May 4, 2016
DEFERRED COMPENSATION
SECTION 409A - BASIC PROVISIONS

- Strict timing rules for NQDC plans:
  – deferral elections
  – distributions
  – funding
- Applies to amounts “deferred” after 2004
  – Plans “grandfathered” if vested at 12/31/04
SECTION 409A - COVERAGE

Supplemental Executive Retirement Plans
Severance Arrangements
Stock Option Plans
Split-Dollar Life Insurance
457(f) Plans
Commission Arrangements
Medical or Other Reimbursements
Arrangements including Tax Gross-Up

Nonqualified Defined Contribution and Defined Benefit Plans
Phantom Stock Plans
401(k) “Wrap” Plans
Excess Benefit Plans
Bonus & Incentive Plans
Employment Agreements
Change in Control Agreements
SECTION 409A - NONCOMPLIANCE

Immediate Income Inclusion
- triggers immediate income inclusion of all amounts deferred under plans of same type

20% Additional Tax On Plan Balance

Additional “Interest Tax”
- Underpayment Rate Plus 1%

California has an additional 5% penalty
- Fed + CA = >75% tax rate
FIXING 409A PROBLEMS

- Plans must be:
  - In written compliance with rules
  - In operational compliance with rules
- Notice 2010-6
  - Allows for certain documentary failures to be corrected
- Notice 2008-113
  - Allows for certain operational failures to be corrected
  - Corrections may include partial penalties
CCA 201521013
INCLUSION IN GROSS INCOME OF DEFERRED COMPENSATION UNDER NONQUALIFIED DEFERRED COMPENSATION PLANS

• IRS Chief Counsel Advice Memo provides that:
  – Stock options with exercise price less than FMV
  – Not in compliance with 409A
  – Cancelled in a given taxable year
  – All options that vested, or will vest as of the end of the year of cancellation are subject to penalty
SHORT-TERM DEFERRALS NOT SUBJECT TO 409A

A payment that occurs within the “2½ month period” following the lapse of a substantial risk of forfeiture

2½ month period:
- Period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.
- If company has a calendar fiscal year, then March 15th of year following lapse of SRF
BONUS STRUCTURES

- If there is no written document, then a bonus paid after March 15 of the year after the bonus vested will violate Section 409A.
- Payments that are in writing to be paid between January 1 and March 15 of the following year can be paid up to the end of that calendar year.
- If you “have to be there to get it” there is no timing rule.
Generally, a Substantial Risk of Forfeiture (SRF) cannot be extended. Reg. Sec. 1.409A-1(d)(1) provides for extension of SRF if:

- “the present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture”

- Materially greater is not defined in the Regs.

CCA provides that 25% additional benefit is materially greater

- Not necessarily a floor value
DEFERRED COMPENSATION - FICA SPECIAL TIMING RULE
DAVIDSON VS. HENKEL - JANUARY 2015

• Section 3121(v)(2) and Treas. Reg. Sec. 31.3121(v)(2)-1
  – FICA tax on deferred compensation must be paid under a “special timing rule”
  – Generally when deferred comp becomes vested, and not paid
  – If special timing rule is not met, FICA is paid on distribution under the “general timing rule”
  – Amount is based on balance at time of payment

• Davidson vs. Henkel
  – Deferred Comp plans are “top-hat plans” and subject to ERISA
  – Company violated ERISA by not paying FICA on lower balance in plan at time of vesting
BONUS ACCRUALS PAID AFTER FYE
SECTION 461 - ALL EVENTS TEST

All Events Test Under Section 461 Provides that three tests must be met:

1. Must establish a liability as of FYE
2. Liability must be determinable with reasonable accuracy
3. Economic Performance must occur within a reasonable period
   - i.e., 2 ½ months after FYE (Reg. 1.404(b)-1T Q&A-2(b)(1))

Failure to meet any one of these results in loss of ability to accrue deduction
AFFORDABLE CARE ACT
FORM 1094/1095 REPORTING

2015 was first year
All companies with 50 or more FTEs must report
- Applicable Large Employers (ALEs)
Similar to Form W-2
- Due to employees by January 31, 2017
- Due to IRS by February 28, 2017 or March 31, 2017 if efiled
Penalties can be severe
- $500 per form
- Maximum of $6 million
Employees will need Form 1095-C for file their 1040s
AFFORDABLE CARE ACT
ALE REPORTING - QUALIFYING OFFER REPORTING METHOD

• Employer certifies that a qualifying offer was made to one or more full-time employees

• Qualifying Offer must
  – Be an offer of MEC providing MV at an employee cost for employee-only coverage not exceeding 9.5% of the mainland federal poverty limit
  – Include an offer of MEC to employee’s spouse and dependents, if any

• Simplified filing
  – If employer can certify a Qualifying Offer was made to one or more employees, then the employer may use simplified reporting for those employees for whom a Qualifying Offer was made for all 12 calendar months
  – Use code “1A” on Form 1095-C
  – A copy of Form 1095-C or a statement furnished to employee with information that employee and spouse and dependents are ineligible for PTC for the calendar year, plus ALE’s contact information
AFFORDABLE CARE ACT VENDOR ASSISTANCE

- Most vendors have stopped taking on new clients
- Massive data problems
  - 3-4 systems must be integrated
  - No systems have coding - must be created
- IRS delayed reporting requirements due to most companies inability to meet deadlines
§ 4980H - EMPLOYER SHARED RESPONSIBILITY

Payment assessed under § 4980H if an “Applicable Large Employer” either:

- Does not offer MEC to 95% of its full-time employees (and their dependents) [$2,000 per each full-time employee; less the first 30 full-time employees (80 for 2015)]

  or

- Coverage offered is not affordable or does not provide minimum value [$3,000 for each employee receiving a subsidy]

  and

- One or more of the full-time employees receive a PTC for purchase of coverage on an Exchange

Potential ASC 450 (FAS 5) Issues...
OPEN DISCUSSION
2016/2017
PAYROLL TAX UPDATE

JAE ERDEKIAN
TAX PARTNER
JAERDEKIAN@BDO.COM
FICA WAGE BASE

- FICA wage base increased to $127,200 from $118,500
  - FICA Max $7,886 (increase of $539 for both employee and employer)
FSA & HSA’S

- Flexible Spending Account (FSA)
  - Health FSA max
    - $2,600
  - Dependent Care FSA max
    - $5,000

- Health Saving Accounts (HSA)
  - HDHP min annual deductible
    - Single $1,300*
    - Family $2,600*
  - HDHP out of pocket max
    - Single $6,550*
    - Family $13,100*
  - HSA max contributions
    - Single $3,400 (up $50)
    - Family $6,750*

* Unchanged from 2016
INDIVIDUAL INCOME TAX RATES

2017 Federal Individual Income Tax Brackets

- All Brackets increase
- 39.6% bracket begins at:
  - Single $418,401 (was $415,051)
  - MFJ $470,701 (was $466,951)

2017 Mass individual increase tax rate

- Ordinary income and long term capital gain 5.1%
- Short term capital gain 12%
## Qualified Parking & Pass Limitations

### Qualified Transportation Fringe:

- **Federal**
  - Vehicle/Transit Pass Limit: **$255/month**
  - Qualified Parking Limit: **$255/month**

- **Mass**
  - Vehicle/Transit Pass Limit: **$130/month**
  - Qualified Parking Limit: **$255/month**

- **2017** - As of now, same
IRS MILEAGE RATE

- 2016 .54¢
- 2017 ?
PERSONAL USE OF CO OWNED AUTO

- Commuting value for employees < $195K
  - $3/day
- Use annual leave value tables for owners and employees > $195K
ADDITIONAL WAGES FOR OWNERS

- 2% S Corp. Shareholder Health Insurance should be included in the W-2 Box 1 and Box 14, subject to Federal and State income tax; (not box 3 or 5)
  - Available as a deduction on the shareholder’s personal income tax return.

- Officers’ Life & Disability Premiums
  - Subject To All Three Withholdings
  - Taxing insurance disability premium should make future disability benefit non-taxable
QUALIFIED RETIREMENT PLAN LIMITS

- 401K, 403(b), most 457 plans remain at $18,000 for 2017.
- Catch up contributions for age 50 and over remains at $6,000.
- IRA contributions remain unchanged at $5,500 plus $1,000 catch up contribution
- Annual Deferred benefit limitation $215,000, up from $210,000
- Annual Deferred Contribution limitation $54,000, up from $3,000
- SEP Limitation remains at 12,500
ABANDONED PROPERTY

- Filing deadline for November 1 (for 12 month ending on June 30)
- Mass Form AP-1
R&D CREDIT PAYROLL TAX OFFSET

- R&D Credit made permanent in 2015.
- R&D Credit can offset AMT
- R&D Credit can offset Payroll taxes for eligible businesses:
  - Gross receipts for 5 years or less
  - 2016 gross receipts less than $5m
  - Max payroll tax credit $250,000
ITINS

- Not used for employment purposes
- Used by Spouse/dependents of resident aliens
- ITINS issued before 2013 need to be renewed.
IDENTITY THEFT TIPS

- Guard Social Security Number
- Theft is usually an inside job
- Consider not over-withholding or over-paying estimated tax
- Guard date of birth
W-2 BOX 12 CODES

► Report to payroll tax Company before year end
  - Group Term Life - Code C
  - Substantiated employee business expense reimbursements - Code L
  - Excludable moving expense paid directly to employee - Code P
  - Income from non-qualified stock options - Code V
  - Employer contributions to HSA’s - Code W
  - Designated Roth Contributions - Code AA
  - Employer Sponsored Health Coverage - Code DD
W-2 BOX 14 CODES

- Freeform Box - Label each item
- Income from personal use of auto via annual lease value tables
- Personal use of auto
- Disability insurance
- Union dues withholding
- Educational assistance payments
- Taxable reimbursements of business expenses not paid under accountable plan, or in excess of amount accounted for
SIGNIFICANT 2016 STATE TAX LEGISLATION

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JAMES BOWDEN
STATE & LOCAL TAX MANAGING DIRECTOR
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SIGNIFICANT 2016 STATE TAX LEGISLATION

Single Sales Factor Apportionment

- Requires single sales factor apportionment for taxable years beginning on or after January 1, 2016.

Numerous combined reporting changes, including:

- Excludes a limited partner’s distributive share of income from an investment partnership from the unitary business, unless the limited partner and the general partner share common ownership.

- Applies the “principles” of the federal consolidated return regulations promulgated under IRC § 1502 to intercompany transactions.

- Requires the elimination of assets and liabilities attributable to transactions with another member of the unitary combined group when computing the capital tax base.

- The tax of a unitary combined group, prior to the surtax and the application of credits, may not exceed the “nexus combined base tax” by $2.5 million.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Numerous combined reporting changes, including (cont’d):

► Eliminates the requirement to publish a list of jurisdictions determined to be tax havens, and excludes a jurisdiction that has entered into a comprehensive income tax treaty with the U.S. from the definition of “tax haven.”

► A non-U.S. corporation includes income in the combined report based on its profit and loss statement, not limited to income effectively connected with the conduct of a U.S. trade or business.

► Eliminates from the list of non-taxable members required to be included in a unitary combined group one that earns more than 20% of its gross income from intangible property or service-related activities, the costs of which are deductible against the income of other members of the group.

Personal Income Tax Nonresident Exclusion

► For taxable years beginning after December 31, 2015, excludes compensation paid to a nonresident individual if the individual spent fewer than 16 days in the state during the taxable year.

► Does not apply to athletes or entertainers.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Corporation Income Tax

▶ Adopts market sourcing for assigning receipts from sales of other than tangible personal property held primarily for sale (effective for taxable years beginning on or after January 1, 2016).

▶ Market sourcing provision includes various assignment rules including:
  - Receipts from services are sourced to the state to the extent the service is used at a location in the state.
  - Receipts from the sale or other disposition of tangible personal property ("TPP"), real property, or intangible property are excluded entirely from the sales factor if such property is not held by the taxpayer primarily for sale in the ordinary course of business.

Personal Income Tax

▶ Adopts single sales factor apportionment and applies to the income of a nonresident individual, including a nonresident partner’s, shareholder’s, and beneficiary’s share of income (effective for taxable years beginning on or after January 1, 2017).

▶ Adopts market sourcing for apportionment (effective for taxable years beginning on or after January 1, 2017).
Flow-Through Withholding Requirement Eliminated

- Eliminates requirement for an entity classified as a partnership or S corporation (‘‘FTE’’) for federal income tax purposes to withhold income tax on an owner’s distributive share of Michigan income (effective for taxable years beginning on or after July 1, 2015).
  - Applies to income of all owners, including nonresident individuals.

- Does not modify the option to file a composite return on behalf of qualifying owners.

- Does not impose any new filing requirements on FTEs.

- The elimination of the withholding requirement shifts the responsibility and liability for making estimated income tax payments from the FTE to the FTE’s owners, unless a composite return is filed.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Commerce Tax

- Adopts regulations to accompany the Commerce Tax that was enacted in June 2015, and which applies to taxable years beginning on or after July 1, 2015.
- Defines “engaging in business” and includes such activities as commencing, conducting, or continuing a business, and the exercise of corporate or franchise powers regarding a business.
  - Expands definition to include 20 activities that may constitute engaging in business.
- Adopts a physical presence nexus standard, but this could change based on a provision in the regulations.
  - “Any other activity that constitutes sufficient nexus to subject the business entity to the commerce tax in a manner consistent with the United States Constitution.”
- Clarifies that an entity doing business in the state with Nevada receipts under the $4 million threshold must file an abbreviated informational report.
- Sources receipts from the sale of a service to the state to the extent the purchaser received benefit from the service in Nevada.
- Exempts a business if it confines its activities in the state to the owning, maintenance, and management of “intangible investments.”
- Allows an employer to take a credit against the Nevada Payroll Tax equal to 50% of the Commerce Tax paid for the preceding taxable year.
Related Member Interest Expense

- Effective for taxable years beginning after December 31, 2015, intercompany interest expense deduction is limited to the greater of:
  - 15% of the taxpayer’s taxable income; or
  - Proportionate share of interest paid or accrued to a person who is not a related member.

- The proportionate share of interest limitation creates a conduit exception where the related member interest exceeds the 15% limitation, and payment of the related member interest can be traced to an unrelated member.
Sales Factor

- When a taxpayer elects to add-back royalty expense paid to a related party (and the royalty income is excluded from income of the related party recipient), the recipient may not exclude the royalty payments from its North Carolina sales factor (effective May 11, 2016).

- Provides the following exclusions from the sales factor (effective for taxable years beginning on or after January 1, 2016):
  - Gross receipts attributable to the notional principal amount of a swap contract or similar financial derivative that generates the cash flow traded in the swap agreement;
  - Dividends treated as foreign source under IRC § 862 (net of related expenses);
  - Subpart F inclusions under IRC § 951;
  - Foreign indirect tax credit gross-up amounts under IRC § 78; and
  - Dividends excluded for federal income tax purposes.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Proposed Market-Based Sourcing for Corporate Income Tax Purposes

- Requires the Department to prepare proposed market-based sourcing regulations for services, intangibles, and banks.
- Legislation is expected to be introduced in the 2017 legislative session.

Sales and Use Tax

- Amends the definition of repair, maintenance, and installation ("RMI") services to clarify that those taxable services include refinishing, cleaning, inspection, and monitoring services (effective January 1, 2017).
  - Specifically exempts a list of 12 RMI services from sales and use tax.
- Repeals the rule that deemed someone engaged in retail trade could not be a real property contractor.
- Provides rules for a mixed real property and RMI services contract (effective January 1, 2017):
  - If the price of the taxable RMI services does not exceed 10% of the contract price, treat the entire contract as a non-taxable real property contract.
  - Otherwise, treat the RMI services as performed under a separate contract.
- Various sales and use tax changes including exemption of certain service contracts sold by motor vehicle dealers and expansion of the Mill Machinery Tax.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Sales/Use Tax

- Broadens the sales and use tax base to include digital goods whether digitally or electronically delivered, streamed or accessed (effective August 1, 2016).
- Specifically defined TPP that is digitally or electronically delivered, streamed or accessed (including updates, support, and maintenance), is subject to tax whether purchased by subscription, singly, or in any other manner.

Amended Corporate Tax Returns

- Requires the Department to act on amended tax returns filed after December 31, 2016 and provide written notice explaining whether it accepts the return within 1 year of filing.

Tax Amnesty Program

- Establishes an amnesty program that will run from April 21, 2017 through June 19, 2017.
- Applies to any tax administered by the Department and to liabilities delinquent as of December 31, 2015, including a liability related to an unfiled return.
- Entitles a participating taxpayer to waiver of all penalties and 50% of interest.
- Imposes a 5% non-participation penalty.
SIGNIFICANT 2016 STATE TAX LEGISLATION

Bank and Trust Company Shares Tax
- Increases the tax rate to 0.95% (beginning with the 2017 return).
- Extends the option to use Method I to source investment income receipts to taxpayers without trading receipts (applies retroactively to January 1, 2014).
- Includes receipts of non-bank subsidiaries in the apportionment factor (beginning with the 2017 return).
- Eliminates the $100,000 minimum receipts nexus threshold (beginning with the 2017 return).
- Clarifies that the subtraction factor applied to bank equity based on holdings of U.S. obligations is to be applied to bank equity after the subtraction for goodwill (applies retroactively to January 1, 2014).
- Provides an exclusion from bank equity for the equity in a foreign bank (phased in ratably over 5 years beginning with the 2019 return).

Tax Credits and Incentives
- Creates and amends many credits and incentives that apply to various taxpayers and tax types (most are available beginning July 1, 2017).
INCOME/FRANCHISE TAX NEXUS CONTROVERSIES AND DEVELOPMENTS

California
Chief Counsel Ruling 2016-03 (July 5, 2016)

- For California Corporation Franchise and Income Tax purposes, sales of TPP and sales from other than TPP (e.g., royalties) must be combined to determine whether the taxpayer is doing business in a specific state under the state’s economic/factor presence nexus statute.

- Deriving royalty income from a licensee’s use of the taxpayer’s trademarks is not a protected activity under P.L. 86-272.
INCOME/FRANCHISE TAX NEXUS CONTROVERSIES AND DEVELOPMENTS

Illinois


- The court sided with the Department and adopted the significant economic presence test used in *Tax Comm’r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006).

- Court held taxpayer had nexus based on the following activity:
  - Collecting millions in fees and interest from Illinois residents;
  - Systematically and continuously soliciting Illinois consumers via telephone, email, and direct mail to apply for credit;
  - Use of Illinois courts to recover debts on delinquent accounts; and
  - Enforcing judgment liens in Illinois.

- Follows court decisions in Indiana, Massachusetts, and West Virginia.
South Carolina

Revenue Ruling No. 16-11 (July 27, 2016)

- Outlines several different activities which the state considers will create nexus for an out-of-state corporation for income tax purposes.

- Updates previously issued guidance and provides a new section addressing certain activities for computer and internet-based transactions.
  - For example, an out-of-state corporation that provides access to its software to South Carolina customers and lacks a physical presence in the state, but (i) has a substantial number of customers with billing addresses in the state, or (ii) earns a substantial amount of revenue from customers in the state, has nexus in South Carolina.
INCOME/FRANCHISE TAX NEXUS CONTROVERSIES AND DEVELOPMENTS

Virginia
Ruling of the Commissioner, P.D. 16-135 (June 24, 2016)

- Taxpayer is a LLC that licenses basic software from a software developer, customizes the software, and resells the customized basic software to the taxpayer’s clients.
- Taxpayer is located and headquartered outside of Virginia.
- The servers from where the software and data are hosted and backed-up (“Data Centers”) are owned, operated and maintained by the developer.
- One Data Center to which the taxpayer has remote access is located in Virginia, but the taxpayer has no access to, or control over, any server.
- All transactions are performed through cloud-computing services.
- If the developer is an independent contractor, and the taxpayer is only purchasing cloud-computing services, such services would not be attributable to the taxpayer for purposes of corporate income tax nexus.
- Rental of servers in Virginia is not a protected activity under P.L. 86-272 and the continuous use of such servers would likely create more than a de minimis connection to Virginia.
INCOME/FRANCHISE TAX APPORTIONMENT TRENDS
## INCOME/FRANCHISE TAX APPORTIONMENT TRENDS

<table>
<thead>
<tr>
<th>Market-Based Sourcing Where Benefit Received</th>
<th>Market-Based Sourcing Where Service Received</th>
<th>Market-Based Sourcing Where Service Delivered</th>
<th>Market-Based Sourcing Where Customer Located</th>
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<td>Arizona (election)</td>
<td>Connecticut</td>
<td>Alabama</td>
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Variety of State Approaches to Market-Based Sourcing

- 23 states now require or provide election to use market-based sourcing for corporate income tax purposes.

- General rules of sourcing services:
  - “Delivered to a location” in the state
  - “Where benefit of the service is received”
  - “Where receipts derived”

- Hierarchy vs. Proportionate approach:
  - Proportionate - services receipts sourced in proportion to the benefit received by the recipient in the state.
  - Hierarchy - apply cascading rule; if cannot comply with rule, move to next.
  - Examples of proportionate states: Georgia, Iowa, Michigan
  - Examples of hierarchy states: MTC, California, Illinois, Massachusetts

- Key differences in hierarchy approaches can result in inconsistent sourcing results.
INCOME/FRANCHISE TAX APPORTIONMENT TRENDS

Variety of State Approaches to Market-Based Sourcing (cont’d)

- Throw-out rules
- “Look-thru rules” for sales of services to customers of, or through, the customer
- Complex regulations vs. simple/general statutory standards
  - Use of examples to illustrate (or implement?) the rule
- Due diligence
  - Some states impose specific due diligence requirements (e.g., New York)
  - Contemporaneous record retention that explains the determination and method of sourcing services
  - Document application of the hierarchy and determination to move to next priority rule
  - Systems may need to be implemented or modified to conform
The “MTC Model” Regulation - Overview

- MTC Model proposed market-based sourcing regulations are still in “Working Draft” form (issued November 30, 2015).
- Currently under a survey of compact member states, the final step before compact member states hold a final vote on the adoption of the package (as of October 4, 2016).
- Serves as the model for the Massachusetts and Rhode Island market-sourcing regulations.
- General rule of sourcing services: “delivered to a location” in the state.
- Throw out rule.
- Uses complex set of cascading rules to source sales of services.
- Public hearing held March 2016; MTC Executive Committee met October 4, 2016 to consider adding mediation language recommended by the ABA when a taxpayer is confronted by conflicting sourcing methodologies regarding services and intangibles.
**UNITARY COMBINED REPORTING**

**“80/20 Company” Exclusions**

- Generally operates as a rule of exclusion from a water’s-edge combined group, but can operate as a rule of inclusion for non-U.S. entities if U.S. assigned apportionment factor is 20% or greater.

- Rule of exclusion or inclusion (applicable to U.S. and non-U.S. organized entities)*

| Alaska (property, payroll and sales) | New Hampshire (property and payroll) |
| Colorado (property and payroll)      | North Dakota (property and payroll)  |
| Connecticut (property and payroll)** | Texas (property and payroll)**       |
| District of Columbia (property, payroll and sales)** | West Virginia (property, payroll and sales)** |
| Illinois (property and payroll)      | Wisconsin (active foreign business income)** |
| Massachusetts (property, payroll and sales)** | |

* May be subject to limitations.

** Recent enactment (e.g., Connecticut 2016).
“80/20 Company” Inclusions

- Rule of inclusion (applicable to non-U.S. organized entities)

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<tr>
<th>California (property, payroll and sales)</th>
<th>Utah (property and payroll)</th>
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<td>Montana (property and payroll)</td>
<td>Vermont (property and payroll)**</td>
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<td>Rhode Island (property, payroll and sales)**</td>
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**Recent enactment.**
UNITARY COMBINED REPORTING
“TAX HAVENS”

“Tax Haven” Rules


► “Blacklist” approach: State’s statute lists specific foreign countries as “tax havens” (MT, OR) and depends on whether the foreign corporation is incorporated in that jurisdiction.
  - CT and DC eliminated their “blacklist” approach, but still include “tax haven” corporations in the water’s edge combined group.

► “Definitional/MTC” approach: Foreign country has no or a nominal tax on net income and has laws that prevent exchange of information, “lacks transparency,” substantive local presence not required, or has created a regime favorable for tax avoidance (CT, DC, RI, WV).

► Alaska approach: Foreign country with no income tax or that imposes a rate that is 90% of the U.S. rate.
CHALLENGES TO RELATED PARTY TRANSACTIONS AND ECONOMIC SUBSTANCE
Pennsylvania
Information Notice 2016-1 (Feb. 19, 2016)

- 72 Pa. Stat. § 7401(3)l.(t) requires the add-back of deductions taken for federal purposes for payments of intangible expenses (and intangible related interest expenses) to related parties.

- The Information Notice provides the Department’s position on:
  - Applicable intangible assets.
  - Direct or indirect intangible expense of costs (including amortization and embedded intangible costs).
  - Interest expenses are presumed “directly related” to an intangible expense if the taxpayer engaged in any intangible expense transaction with the related party.
  - Add-back exceptions: Principal purpose transactions, arm’s-length, foreign treaty, and conduit.
  - Application of the “subject to tax” credit.
Virginia


- Virginia’s “subject to tax” exception to the related party intangible expense and interest expense add-back statute requires that the related party recipient of the intangible/interest income must actually pay an income tax to another state.

- Taxpayer paid intangible expenses to a related party that was included with the taxpayer in another state’s unitary combined report (the intangible income and intangible expense offset in the combined report).
DEBT-EQUITY CONSIDERATIONS

Massachusetts

*National Grid Holdings, Inc. v. Commissioner of Revenue*, No. 14-P-1662 (June 8, 2016) and *National Grid USA Service Co., v. Commissioner of Revenue*, No. 14-P-1861 (June 8, 2016)

- Both companies were members of the Massachusetts combined group.
- DSAs were structured to be debt for U.S. tax purposes and equity for U.K. tax purposes.
- Grid Holdings - Court held that DSAs between U.K. parent corporation and various U.S. subsidiaries did not constitute true indebtedness.
  - Court examined the tax motivation behind the DSA structure, sophistication of the parties, and the fact that the parties could have used more appropriate and less ambiguous language when drafting the agreement.
  - No evidence that similar financing could have been obtained from outside sources.

- Grid USA - A closing agreement entered into between the taxpayer and the IRS pursuant to which a portion of the interest expense on a DSA was allowed as a deduction for federal income tax purposes was not binding on the state.
INCOME/FRANCHISE TAX BASE
INCOME/FRANCHISE TAX BASE

Pennsylvania


- Court held that the state’s net operating loss deduction (“NOLD”) limitation, as applied to the taxpayer, violates the Uniformity Clause of the Pennsylvania Constitution.
- 2007 NOLD limitation limits the use of NOLDs to the greater of $3 million or 12.5% of taxable income.
- Court granted the taxpayer full use of its NOL carryovers.
- NOLD limitation creates classes of taxpayers according to their taxable income.
- Appeal was filed on January 20, 2016, and is currently before the Pennsylvania Supreme Court.


- Court held that 2006 NOLD violates the Uniformity Clause of the Pennsylvania Constitution.
- Court granted the taxpayer full use of its NOL carryovers, an outcome that matches the remedy in *Nextel*. 
South Carolina
Revenue Ruling No. 16-7 (July 6, 2016)

- Discusses the application of IRC § 382 as it relates to a multi-state SC taxpayer.
- Since SC typically requires separate company reporting, the SC 382 Limitation of a multi-state corporation is the product of the federal 382 Limitation of the loss corporation as calculated on a separate company basis, and the loss corporation’s SC apportionment percentage for the year in which the ownership change occurs.
- Addresses the SC 382 Limitation adjustments necessary for recognized built-in gains and losses.
- Applies to all periods open under statute.
California

Technical Advice Memorandum 2016-01 (July 12, 2016)

- Texas franchise tax is a tax on gross receipts, not on income.
- For California personal income tax purposes, the Texas franchise tax is not included in the computation of credit for taxes paid to other states.
- May have implications for corporations - taxpayers may not be required to add back Texas franchise tax in computing California taxable income if the tax is a non-income tax.
MANAGING A SALES TAX AUDIT
MANAGING A SALES TAX AUDIT

► Why Did I Get Selected?
   - Audit conducted of your customer
   - Matching program
   - Research performed
   - It’s your turn

► Hot Areas to Audit
   - Drop shipments
   - Multiple points of use
   - Software, software, software...
MANAGING A SALES TAX AUDIT

- Audit Preparation
  - Conduct a self-audit
  - Know how to select appropriate sample with auditor
  - Understand accounts to be audited
  - Obtain exemption/resale certificates
MANAGING A SALES TAX AUDIT

During the Audit
- Understand information being requested
- Keep track of information provided
- Provide steady flow of information to auditor
- Stay in contact with auditor
- Maintain positive relations
- Address requests timely and accurately
MANAGING A SALES TAX AUDIT

- **Closing the Audit**
  - Do you agree or disagree?
  - Understand options and deadlines available for appeal of findings
  - Penalties
  - Quick payment

- **Next Steps**
  - Fix issues identified during audit
INTERNATIONAL TAX HOT TOPICS

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AGENDA

I. Regulations under § 385
   • Overview of the proposed regulations issued on April 4, 2016
   • Highlights of Significant Changes
   • Illustrations of Final Regulations

II. Proposed §367(d) Regulations

III. Splitter Notice: Notice 2016-52

IV. Tax Treaty Updates

V. Section 956 Final Regulations

VI. Potential Upcoming Regulations
I. REGULATIONS UNDER § 385

Overview of the proposed regulations issued on April 4, 2016
PROPOSED § 385 REGULATIONS - IN GENERAL

• On April 4, 2016, the IRS released REG 108060-15, containing proposed regulations under section 385.
• Authorized the IRS to treat certain related-party interests in certain corporations as indebtedness in part and as stock in part for U.S. federal tax purposes. Prop. Reg. § 1.385-1(d).
• Authorized the IRS to establish threshold substantiation and documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for U.S. federal tax purposes. Prop. Reg. § 1.385-2.
• Treated as stock certain related-party interests that otherwise would be treated as indebtedness for U.S. federal tax purposes. Prop. Reg. § 1.385-3.
PROPOSED § 385 REGULATIONS - IN GENERAL

- The proposed regulations were drafted such that they affected corporations that issue purported indebtedness to certain related corporations (also special rules relating to certain controlled partnerships e.g., former Prop. Reg. § 1.385-3(d)(5)).
- The proposed regulations were drafted very broadly (e.g., they could apply to foreign-to-foreign transactions)
- The proposed regulations included several operating rules (rules for defining when members of a group are related for purposes of applying rules, certain threshold exceptions and specific exceptions relating to application of rules, anti-abuse rules, predecessor and successor rules, anti-avoidance, coordination rules, etc.).
  - For instance, the proposed section 385 regulations applied a broad 80% threshold for finding expanded group members that included certain entities such as S-corporations. See, former Prop. Reg. § 1.385-1(b)(3) for additional details.
The bifurcation rule of Prop. Reg. § 1.385-1 generally was proposed to apply to debt instruments issued on or after the date the regulations are finalized.

The substantiation and documentation rules in Prop. Reg. § 1.385-2 were proposed to apply to debt instruments issued on or after the date the regulations are finalized.

The automatic recast rules of Prop. Reg. § 1.385-3 were proposed to apply to debt instruments issued on or after April 4, 2016; however, recharacterization under these rules were proposed to occur 90 days after the date the final regulations were issued for instruments that would be treated as stock prior to regulations being finalized (see former Prop. Reg. § 1.385-3(h) for additional details).

The rules relating to consolidated groups generally were proposed to apply to debt instruments issued on or after April 4, 2016 with special 90 day rule with respect to debt instruments that would be treated as stock prior to date of final regulations.

The proposed section 385 regulations included rules to address CTB elections to avoid effective dates.
PROPOSED § 385 REGULATIONS - DOCUMENTATION REQUIREMENTS

- Documentation requirements are a necessary, but not sufficient, condition for treatment as indebtedness for federal tax purposes.

- Legally binding obligation to pay.

- Creditors’ rights to enforce the obligation.

- Reasonable expectation of repayment at the time the interest is created.
PROPOSED § 385 REGULATIONS - DOCUMENTATION REQUIREMENTS

- Ongoing relationship during the life of the interest consistent with arms-length relationships between unrelated debtors and creditors (genuine debtor-creditor relationship) subject to documentation requirements.
- The proposed section 385 regulations included rules regarding when documentation must occur (i.e., the 30-day and 120-day rules) and also provided some limitations to the applicability of the above documentation requirements.
- The documentation rules generally apply if:
  - stock of any of expanded group is publicly traded;
  - All or any portion of the expanded group’s financial results are reported on financial statements with total assets exceeding $100 million; or
  - The expanded group’s financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.
PROPOSED § 385 REGULATIONS - PRESUMED EQUITY

- Distributions of debt instruments by corporations to certain related corporate shareholders.

- Issuances of debt instruments by corporations in exchange for stock of certain affiliated corporations (including “hook stock” issued by certain related corporate shareholders).

- Certain issuances of debt instruments as consideration in an exchange part of to an internal asset reorganization.
PROPOSED § 385 REGULATIONS - PRESUMED EQUITY

• The proposed section 385 regulations treated as stock certain related-party debt instruments (a principal purpose debt instrument or funding rule) issued in a separate transaction to fund:
  - A distribution of cash or other property to a related corporate shareholder
  - An acquisition of stock from an affiliate
  - Certain acquisitions of property from an affiliate pursuant to an internal asset reorganization

• Under a 72 month “per se” rule in the proposed section 385 regulations (subject to certain ordinary course debt if certain requirements are satisfied): a principal purpose was deemed to exist if the expanded group debt instrument is issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition.
The proposed section 385 regulations included several special rules and numerous operating rules in applying the above rules and also included some exceptions to the applicability of the above rules.

Exceptions include:
- Current E&P limitation
- Funded subsidiary exception
- Threshold exception
  - threshold exception provided that an expanded group debt instrument not treated as stock if when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under the proposed regulations does not exceed $50 million (but cliff effect if exceed limit)
I. REGULATIONS UNDER § 385

Highlights of Significant Changes
After the Proposed Regulations were issued, the Treasury and the Service received numerous written comments in response to the Proposed Regulations. Many of these comments criticized the broad application of the rules. In addition, many of the comments expressed concern that the Proposed Regulations would impose compliance burdens and result in collateral consequences that were not justified by the stated policy objectives of the Proposed Regulations. On October 13, 2016, the Treasury and the Service issued final and temporary regulations under Section 385. In response to the comments received, the final and temporary regulations substantially revise the proposed regulations. The final and temporary regulations significantly reduce the scope and breadth of the rules by including several important exclusions and exceptions relating to the application of the rules.
The changes significantly reduce the number of taxpayers and transactions affected by the Final and Temporary Regulations; Thus, although the final and temporary regulations retain §§1.385-2 and 1.385-3, as narrowed, many issuers are entirely exempt from the application of §§1.385-2 and 1.385-3.

Moreover, with respect to the large domestic issuers that are subject to §1.385-3, that section has been substantially revised to better focus on extraordinary transactions that have the effect of introducing related-party debt without financing new investment in the operations of the issuer.
The following represent some of the significant changes made to the proposed regulations by the final and temporary regulations.

Changes to the overall scope of the regulations:

- **Exclusion of foreign issuers.** The final regulations reserve on all aspects of their application to foreign issuers; as a result, the final regulations do not apply to foreign issuers.

- **Exclusion of S corporations and non-controlled RICs and REITs.** S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the final regulations.
Changes to the overall scope of the regulations:

- **Removal of general bifurcation rule.** The final regulations do not include a general bifurcation rule. The Treasury Department and the IRS will continue to study this issue.

- **Modification to the definition of expanded group.** The final regulations made certain modifications to the definition of expanded group to make it more targeted.
Significant changes to the documentation requirements in §1.385-2:

- **Extension of period required for timely preparation.** The final regulations eliminate the proposed regulations’ 30-day (and 120-day) timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer’s federal income tax return is filed (taking into account all applicable extensions).

- **Rebuttable presumption based on compliance with documentation requirements.** The final regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements (regulations provide conditions that must be satisfied), then a rebuttable presumption, rather than per se re-characterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.

- **Delayed implementation.** The final regulations apply only to debt instruments issued on or after January 1, 2018.
FINAL AND TEMPORARY § 385 REGULATIONS - SIGNIFICANT CHANGES

- Significant changes to the documentation requirements in §1.385-2:
  - *Rules relating to regulated financial services entities and insurance companies.* The final regulations clarify the application of the documentation rules to certain interests issued by regulated financial services entities and insurance companies that are required by regulators to include particular terms.

  - *Documentation rules and Master Agreements.* The final regulations clarify the ability of expanded group members to satisfy the documentation rules for EGIs issued under revolving credit agreements, cash pooling arrangements, and similar arrangements by establishing overall legal arrangements (master agreements).
FINAL AND TEMPORARY § 385 REGULATIONS - SIGNIFICANT CHANGES

- Significant changes to the recast/funding rules included in §1.385-3:
  - Exclusion of debt instruments issued by regulated financial groups and insurance entities. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.
  - Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of §1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs that meet certain requirements.
  - Limiting certain “cascading” re-characterizations. The final and temporary regulations narrow the application of the funding rule by preventing, in certain circumstances, the so-called “cascading” consequence of re-characterizing a debt instrument as stock.
Significant changes to the recast/funding rules included in §1.385-3:

- **Expanded earnings and profits exception.** The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued. Special rules apply when there is a change in control.

- **Expanded access to $50 million exception.** The final and temporary regulations remove the “cliff effect” of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be re-characterized.

- **Credit for certain capital contributions.** The final and temporary regulations provide an exception pursuant to which certain contributions of property are “netted” against distributions and transactions with similar economic effect.
Significant changes to the recast/funding rules included in §1.385-3:

- **Exception for equity compensation.** The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services if certain conditions are satisfied.

- **Expansion of 90-day delay for re-characterization.** The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded so that any debt instrument that is subject to re-characterization but that is issued on or before the date that is 90 days after the date of publication in the federal register will not be re-characterized until immediately after the date that is 90 days after the date of publication in the federal register.
The final and temporary Regulations apply to taxable years ending on or after the date 90 days after the date on which the regulations are published in the Federal Register.

The documentation requirements in the final regulations under §1.385-2 do not apply to interests issued or deemed issued before January 1, 2018.

The recast rules in final and temporary Regulations under §§ 1.385-3 and 1.385-3T grandfather debt instruments issued before April 5, 2016 (rather than before April 4, 2016 as was provided in the Proposed Regulations). The final and temporary regulations in §1.385-3(b)(3)(viii) also grandfather distributions and acquisitions occurring before April 5, 2016, for purposes of applying the funding rule.
FINAL AND TEMPORARY § 385 REGULATIONS - EFFECTIVE DATES

- Debt instruments that are issued between April 5, 2016 and 90 days after publication of the final regulations in the Federal Register that would be re-characterized as stock by operation of the final regulations are deemed to be exchanged for stock on the 91st day after the final regulations have been published.
- See above regarding the expansion of the 90-day delay for re-characterization.
- For more details regarding the dates of applicability, see §§ 1.385-1(f), 1.385-2(i), 1.385-3(j), 1.385-3T(k), 1.385-4T(g) and 1.752-2T(l)(4).
- For more details on these rules and changes made in the final and temporary regulations, see the final and temporary regulations (https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-25105.pdf).
I. REGULATIONS UNDER § 385

Illustrations of Final Regulations
PER SE STOCK RULE
GENERAL RULE: NOTE DISTRIBUTION ILLUSTRATION

**Step**
- US Sub declares a dividend and distributes $100 note to Foreign Parent in payment thereof

**Intended Results**
- US Sub note issued to an Expanded Group member in a distribution
- Assume no exceptions apply
- US Sub note treated as stock
**PER SE STOCK RULE**

**GENERAL RULE: TRIANGULAR B REORGANIZATION ILLUSTRATION**

**Steps**
1. US Sub issues a $100 note to Foreign Parent in exchange for Foreign Parent stock on Date A in Year 1.
2. US Sub transfers Foreign Parent stock received in the prior step to US Target shareholders in exchange for all of US Target stock on Date B in Year 1.
   - US Target shareholders are not members of Foreign Parent Expanded Group.

**Intended Results**
- US Sub note issued to an Expanded Group member in acquisition of Expanded Group member stock even though such stock is transferred, pursuant to the same plan, to persons that are not members of the Expanded Group.
- Assume no exceptions apply.
- US Sub note treated as stock when it is issued on Date A in Year 1.
**PER SE STOCK RULE**

**GENERAL RULE: SECTION 304 TRANSACTION ILLUSTRATION**

**Step**
- US Acquirer issues a $100 Note to Foreign Parent in exchange for US Target stock

**Intended Results**
- US Acquirer note issued to an Expanded Group member in exchange for Expanded Group stock
- US Acquirer note treated as stock
- Assume no exceptions apply
- US Acquirer note (now stock) not treated as “property” for Sections 304(a) and 317(a) purposes
**PER SE STOCK RULE**

**GENERAL RULE: D REORGANIZATION ILLUSTRATION**

**Steps**
1. US Acquirer issues a $100 Note to Foreign Parent in exchange for US Target stock
2. US Target converts to a LLC

**Intended Results**
- US Acquirer note issued to an Expanded Group member in exchange for property in an asset reorganization, and pursuant to a plan of reorganization, an Expanded Group member immediately before the reorganization receives the debt instrument with respect to its US Target stock
- Assume no exceptions apply
- US Acquirer note treated as stock
**Steps**

1. US Parent and US Sub are not members of a consolidated group
2. On Date A in Year 1, Foreign Parent lends $200 to US Sub in exchange for Note A
3. On Date B in Year 1, US Sub distributes $400 of cash to US Parent
4. On Date C in Year 2, Foreign Parent lends an additional $300 to US Sub in exchange for Note B

**Intended Results**

- Note A is treated as funding the distribution by US Sub to US Parent because Note A is issued to an Expanded Group member during the per se period with respect to US Sub’s distribution to US Parent
  - Note A is treated as stock on Date B in Year 1 (absent application of any exceptions)
  - Note B is also issued to an Expanded Group member during the per se period with respect to US Sub’s distribution to US Parent
- Note B is treated as funding only the remaining portion of the distribution, $200
  - $200 of Note B is treated as stock on Date C in Year 2 (absent application of any exceptions)
- The remaining $100 of Note B continues to be...
PER SE STOCK RULE
FUNDING RULE

Intended Results (Cont’d)
- Note B is also issued to an Expanded Group member during the per se period with respect to US Sub’s distribution to US Parent
- Note B is treated as funding only the remaining portion of the distribution, $200
  - $200 of Note B is treated as stock on Date C in Year 2 (absent application of any exceptions)
- The remaining $100 of Note B continues to be treated as debt
II. PROPOSED § 367(D) REGULATIONS
OUTBOUND SECTION 351 TRANSACTION

- USP, a domestic corporation, makes a CTB election to treat FS, a disregarded entity, as a foreign corporation.
- Incorporation treated as a section 351 transaction.
- Assume foreign goodwill/going concern transferred in incorporation.

Before

USP

FS

After

USP

FS
OVERVIEW OF REG-139483-13

- Eliminates the favorable treatment afforded foreign goodwill and going concern value by removing the foreign goodwill and going concern value exception under section 367(d) and limiting the scope of the active trade or business exception under section 367(a) generally to certain tangible property and financial assets.

- Thus, under the proposed regulations, upon an outbound transfer of foreign goodwill and going concern value, a U.S. transferor will either (i) currently recognize gain realized under section 367(a) or (ii) annually include an amount in gross income under section 367(d).

- Although the proposed regulations do not address whether foreign goodwill and going concern value is a section 936 intangible, the proposed regulations allow taxpayers taking the position that certain intangible property is not described in section 936(h)(3)(B) and therefore is not subject to section 367(d) to choose to apply section 367(d) to such property rather than recognizing immediate gain with respect to that intangible property under section 367(a).
OVERVIEW OF REG-139483-13

- Eliminates the favorable treatment afforded foreign goodwill and going concern value by removing the foreign goodwill and going concern value exception under section 367(d) and limiting the scope of the active trade or business exception under section 367(a) generally to certain tangible property and financial assets
- Modifies the §1.367(a)-1T regulations to provide that the value of property transferred outbound must be determined under section 482 in the case of controlled transactions
- Removes the definition of foreign goodwill and going concern value
- Eliminates the 20-year limitation on useful life for purposes of applying section 367(d)
- To facilitate the narrowing of the scope of the active trade or business exception and to make the regulations concerning the active trade or business exception more accessible, combines portions of those existing regulations into a single regulation
OVERVIEW OF REG-139483-13

• Removes the foreign currency exception to the statutory rule and provides that foreign currency and other property denominated in a foreign currency are ineligible for the active trade or business exception

• Eliminates special rules for outbound transfers to FSCs because FSC rules have been repealed

• Modifies the scope of property subject to a depreciation recapture rule to include section 126 property (as defined in section 1255(a)(2))

• Makes conforming changes to the information reporting requirements under the section 6038B regulations
OVERVIEW OF REG-139483-13

• The proposed regulations would generally apply (i) to transfers occurring on or after September 14, 2015, and (ii) to transfers occurring before September 14, 2015, that result from “retroactive” entity classification elections filed on or after that date.

• In the case of the removal of the foreign currency exception, the effective date would be prospective based on when the proposed regulations are finalized.

• Finalization soon???
III. SPLITTER NOTICE

Notice 2016-52
NOTICE 2016-52

- Notice 2016-52 issued on September 15, 2016 addresses new foreign tax credit “splitter” arrangements

- Applies to situations where a section 902 corporation pays foreign income taxes under a specified “foreign initiated adjustment” which relate to prior years and the additional foreign income tax liability is greater than $10 million, regardless of whether such liability is actually paid in one or more taxable years
  - Before payment, a taxpayer may attempt to change its ownership structure or cause the section 902 corporation to make an extraordinary distribution so that the subsequent taxes paid create a high tax pool of post-86 undistributed earnings
NOTICE 2016-52

- Notice identifies two new splitter arrangements relating to section 902 corporations that pay foreign income taxes pursuant to certain foreign initiated adjustments

- New splitter arrangement #1
  - As a result of a “covered transaction,” a section 902 corporation pays “covered taxes’ during a taxable year

- Exceptions
  - The transaction or series of related transactions results in the transfer of the predecessor entity’s E&P to the payor pursuant to §381(c)(2)
  - Taxpayer demonstrates by clear and convincing evidence that the transaction or series of related transactions were not structured with a principal purpose of separating covered taxes from the post-86 undistributed earnings of the predecessor entity that include the earnings to which the covered taxes relate
NOTICE 2016-52

- New splitter arrangement #2
  - A section 902 corporation pays “covered taxes” during a taxable year, and the payor (or a predecessor of the payor) has made a “covered distribution”

- Distribution presumed to have been made with a principal purpose of reducing the payor’s post-86 undistributed earnings that included the earnings to which the covered taxes relate in advance of the payment of covered taxes if:
  - The sum of all distributions that would be covered distributions without regard to the principal purpose requirement is greater than 50% of the sum of (i) the payor’s post-86 undistributed earnings as of the beginning of the payor’s taxable year in which the covered tax is paid and (ii) the sum of all distributions that would be covered distributions without regard to the principal purpose requirement

- May rebut this presumption with “clear and convincing evidence”
Notice specifically provides that no inference is to be made whether payments made pursuant to a foreign initiated adjustment is a creditable tax.

Effective to foreign income taxes paid on or after September 15, 2016.
IV. TAX TREATY UPDATES
TAX TREATY UPDATE

• Many tax treaties are awaiting U.S. Senate Ratification (Hungary, Japan, Chile, etc.)
• Other treaties currently in various stages of negotiation
• BEPS Action Plan
• 2016 Model Treaty
2016 MODEL TREATY

- Prior Model Treaty is 2006 Model
- Major Areas of Change from 2006 Model
- Draft Model Treaty was released in May 2015
- 2016 Model Treaty and Technical Explanation released in February 2016
2016 MODEL TREATY

Key areas of change-

• Special Tax Regimes (STR)
• A new Limitation on Benefits (LOB) article
• Payments by “Expatriated Entities”
• Subsequent Changes in Law
• “Exempt Permanent Establishments”
SPECIAL TAX RATE (STR) (ARTICLE 3 - DEFINITIONS)

Any statute, regulation, or administrative practice that satisfies 5 conditions:

1. Preferential tax rate or reduction in tax base for passive income or companies that do not engage in active trade or business

2. In the case of a preferential tax rate for royalties, not conditioned on R&D in the state granting favorable rate

3. Generally expected to result in tax rate equal to lesser of 15% or 60% of the general statutory rate in the state granting the favorable rate

4. Does not apply principally to pension funds, typical tax-exempt organizations, or RIC or REIT equivalents

5. Identified as “problem regime” through diplomatic channels and placed on formal list of special tax regimes
LOB CHANGES (ARTICLE 22)

- More robust base erosion test (public subsidiary, ownership/base erosion, derivative benefits, and headquarters company tests)
- Public subsidiary test
- New derivative benefits test
- New headquarters company test
- More limited active trade or business test
ACTIVE TRADE OR BUSINESS TEST (ARTICLE 22)

• Summary of rule: If a company conducts an active trade or business in its residence state, it is eligible for treaty benefits on income derived from the source state that “emanates from” or is incidental to that trade or business.

• If the income is derived from a connected person or an activity conducted by the company in the source state, the company’s trade/business in its residence state must be substantial in relation to the relevant trade/business carried on in the source state.

• Active trade or business for these purposes does not include: holding companies, group financing, group supervision and administration, and making or managing investments.
ACTIVE TRADE OR BUSINESS TEST (ARTICLE 22)

- Activities can be attributed by “connected persons” (generally requiring at least 50% ownership).

- The relevant income must now “emanate from” or be incidental to the active trade/business. In the 2006 Model and current treaties, income must generally be derived “in connection with” or be incidental to the active trade or business (e.g., Canada, Germany, Belgium, France).

- Factual connection between the active trade or business in the residence country and the relevant item of income. The mere fact that two companies are in similar lines of business is not sufficient.
SUBSEQUENT CHANGE IN LAW (ARTICLE 28)

- Triggers a renegotiation of treaty
- Occurs when a reduction in statutory tax rate of one contracting state below lesser of: 15% or 60% of statutory rate in other contracting state

- Effect: Treaty amendment OR
- If negotiations don’t progress, then after 6 months’ notice, terminate the following articles:
  - Dividends [Article 10]
  - Interest [Article 11]
  - Royalties [Article 12]
  - Other Income [Article 21]
V. SECTION 956 FINAL REGULATIONS
Overview
• US Parent wholly owns Foreign Sub and an interest in Foreign Partnership
• At the close of Q1, year 1, US Parent’s liquidation value with respect to Foreign Partnership is 90%
• X, a foreign unrelated person, owns the remaining interests in Foreign Partnership
• Foreign Partnership borrows $100 from Foreign Sub. Foreign Sub’s basis in the obligation is $100

Intended Results
• Under Reg. §1.956-4(c)(1), Foreign Partnership obligation is treated as obligations of its partners in proportion to each partner’s liquidation value percentage with respect to Foreign Partnership
• US Parent’s share of the obligations is $90
• $90 of the Foreign Partnership obligation held by Foreign Sub treated as an obligation of US Parent (i.e., Section 956 US property)
• On the date the loan is made, Foreign Sub treated as holding US property of $90
VI. POTENTIAL UPCOMING REGULATIONS
POTENTIAL UPCOMING REGULATIONS

- 901(m) - Denial of FTCs with respect to foreign income not subject to US taxation by reason of CAAs
- 987 - F(x) gain/loss for certain branch transactions
- 367(d) - Outbound transfers of intangibles
- 721(c) - Notice 2015-54
DISCLAIMER

This document is not written tax advice directed at the particular facts and circumstances of any person. This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. If you are interested in the subject of this document we encourage you to contact an independent tax advisor to discuss the potential application to your particular situation.
TAXABLE ACQUISITION STRUCTURES INVOLVING S CORPORATIONS

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Facts and Assumptions:
- S Corp is a Delaware S corporation in business since 1990.
- S Corp engages in 100% of its business in New Jersey and SH is a Nevada resident.
- S Corp has a FMV of $100m and has $0 basis in its assets.
- S Corp has inventory and other assets that would generate ordinary income (approximately 20% of the assets).
- SH has a $0 basis in S Corp stock.
- Buyer wants to acquire 80% or 70% of S Corp.
- Assume the net investment income tax does not apply.

Scenarios:
- Buyer acquires the S Corp stock.
- Buyer acquires the stock with a Section 338(h)(10) election.
- Buyer is deemed to acquire the S Corp assets.
- The S Corp assets are transferred to a newly formed partnership and Buyer acquires a partnership interest.
PURCHASE OF 80% OF AN S CORPORATION
SCENARIO 1

Purchase of 80% of an S corporation:

- Stock transaction
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership structure
SCENARIO 1: PURCHASE OF 80% OF STOCK

Scenario 1
- Buyer buys 80% of the S Corp stock.

Tax implications:
- SH is subject to federal income tax of $16m at 20% on the capital gain of $80m.
- SH is not subject to state income tax because NV doesn’t impose an income tax on individuals.
- SH’s net proceeds = $80m - $16m = $64m.
- The S status of S Corp is terminated and it becomes a C corporation.

### Post-deal structure:

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
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<tbody>
<tr>
<td>Proceeds</td>
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<td></td>
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<tr>
<td>Federal tax</td>
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SCENARIO 2

Purchase of 80% of an S corporation:

- Stock transaction
- **Stock transaction with a Section 338(h)(10) election**
- Asset transaction
- Partnership structure
SCENARIO 2: PURCHASE OF 80% OF STOCK WITH ELECTION TO TREAT AS ASSET PURCHASE

**Scenario 2**
- Buyer buys 80% of S Corp stock and makes a Section 338(h)(10) election. Alternatively, an election under Section 336(e) may be available.

**Tax implications:**
- S Corp recognizes gain on deemed sale of 100% of its assets:
  (i) Fed CG tax: $16m at 20% on capital gain of $80m;
  (ii) Fed OI tax: $7.92m at 39.6% on ordinary income of $20m
  (iii) NJ tax: $8.97m at 8.97% on gain of $100m,
- SH recognizes no gain on the liquidation of S Corp to extent of its stock basis.
- Step-up benefit for 100% of the assets is available although shared 80/20 between Buyer and the shareholder of the former S Corp. The anti-churning rule does not apply as SH is retaining only 20%.
- The S status of S Corp is terminated and it becomes a C corporation.

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<tr>
<th>Scenario</th>
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*NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate
SCENARIO 3

Purchase of 80% of an S corporation:
- Stock transaction
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership transaction
SCENARIO 3: PURCHASE OF 80% OF ASSETS

Scenario 3
1. SH forms New S Corp and transfers S Corp stock (“Old S Corp”) to New S Corp.
2. Old S Corp converts into an LLC. Steps 1&2 are treated as an F reorganization.
3. Buyer purchases 80% of LLC interest from S Corp,

Tax implications:
- New S Corp recognizes gain on the asset sale ($80), 80% of which is taxed at the capital gains rate and 20% at the ordinary income tax rate:
  (i) Fed CG: $12.8m at 20% on capital gain of $64m
  (ii) Fed OI: $6.34m at 39.6% on ordinary income of $16m
  (iii) NJ tax: $7.18m at 8.97% on gain of $80m.
- Step-up benefit for 80% of the assets (PV $16.23m) is available but shared 80/20 between S Corp and Buyer absent remedial allocation. The anti-churning rule does not apply as SH retains only 20%.

Post-deal structure:

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<td>PV of step-up*</td>
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<td>$16.2m</td>
<td>$12.9m**</td>
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*NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate.
**Step-up benefit is split 80/20 between Buyer and S Corp absent remedial allocation.
SCENARIO 4

Purchase of 80% of an S corporation:
- Stock transaction
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership structure
SCENARIO 4: PURCHASE OF 80% OF NEW PARTNERSHIP

Scenario 4
1. SH forms New S Corp and transfers S Corp stock ("Old S Corp") to New S Corp.
2. Old S Corp converts into an LLC. Steps 1 & 2 are treated as an F reorganization.
3. New S Corp distributes 1% of Old S Corp stock to SH.
4. Buyer buys 80% of LLC interest from S Corp.

Tax implications:
- SH recognizes gain on the 1% distribution, resulting in Fed CG tax of $0.2m at 20% on capital gain of $1m.
- New S Corp recognizes gain on the sale of 80% LLC interest which results in:
  (i) Fed CG: $12.8m at 20% on capital gain of $64m
  (ii) Fed OI: $6.34m at 39.6% on ordinary income of $16m
  (iii) NJ tax: $7.18m at 8.97% on gain of $80m.
- S Corp status as an S corporation is preserved, and SH rolls over his 20% interest.
- The 1% distribution results in added tax of $0.2m yet enables Buyer to make a Section 754 election to obtain a full step-up benefit without special allocation.

Post-deal structure:

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<td>PV of step-up*</td>
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<td>$16.2m</td>
<td>$12.9m</td>
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*NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate.
SCENARIO 4.1: PURCHASE OF 80% OF NEW PARTNERSHIP PLUS LEVERAGE

Scenario 4.1
1. SH drops transfers S Corp stock (“Old S Corp”) to New S Corp.
2. Old S Corp converts into an LLC. Steps 1&2 are treated as an F reorganization.
3. New S Corp distributes 1% of Old S Corp stock to SH.
4. Old S Corp borrows $30m from a bank and distributes the proceeds to SH and New S Corp.
5. Buyer buys 80% of LLC interest from S Corp for $56m cash.

Tax implications:
- SH recognizes gain on the 1% distribution, resulting in Fed CG tax of $0.2m at 20% on capital gain of $1m.
- New S Corp recognizes gain on the sale of 80% LLC interest ($56m cash and $24m relief of liability), resulting in:
  (i) Fed CG: $12.8m at 20% on capital gain of $64m
  (ii) Fed OI: $6.34m at 39.6% on ordinary income of $16m
  (iii) NJ tax: $7.18m at 8.97% on gain of $80m.
- The tax implications are the same as Scenario 4, except SH receives additional proceeds of $6m which is not taxed as a debt-financed distribution.

Post-deal structure:

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*NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate.
PURCHASE OF 70% OF AN S CORPORATION
SCENARIO 1

Purchase of 70% of an S corporation:

- **Stock transaction**
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership structure
SCENARIO 1: PURCHASE OF 70% OF STOCK

Scenario 1
- Buyer buys 70% of the S Corp stock.

Tax implications:
- SH is subject to federal income tax of $14m at 20% on the capital gain of $70m.
- SH is not subject to state income tax because NV does not impose an income tax.
- SH net proceeds = $70m - $14m = $56m.
- The status of S Corp as an S corporation is terminated as it now has a corporate shareholder. It is treated as a C corporation.

Post-deal structure:
SCENARIO 2

Purchase of 70% of an S corporation:

- Stock transaction
- **Stock transaction with a Section 338(h)(10) election**
- Asset transaction
- Partnership structure
SCENARIO 2: PURCHASE OF 70% OF STOCK AS INSUFFICIENT TO TREAT AS ASSET PURCHASE

Scenario 2
- A Section 338(h)(10) election is not available as Buyer is acquiring only 70% of the S Corp stock, which is not a qualified stock purchase for purposes of making this election.
- An election under Section 336(e) likewise is not available either as Buyer is acquiring only 70% of the S Corp stock, which is not a qualified stock disposition for purposes of making this election.

Tax implications:
- The status of S Corp as an S corporation is terminated as it now has a corporate shareholder. It is treated as a C corporation.

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
<th>Scenario 4</th>
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<tbody>
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<td>PV of Step-up</td>
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</table>
SCENARIO 3

Purchase of 70% of an S corporation:

- Stock transaction
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership structure
SCENARIO 3: PURCHASE OF 70% OF ASSETS

**Scenario 7**
1. SH forms New S Corp and drops down S Corp stock (“Old S Corp”) to New S Corp.
2. Old S Corp converts into an LLC. Steps 1&2 are treated as an F reorganization.
3. Buyer buys 70% of LLC interest from S Corp.

**Tax implications:**
- New S Corp recognizes gain on the deemed asset sale, resulting in:
  (i) Fed CG: $11.2m at 20% on capital gain of $56m
  (ii) Fed OI: $5.54m at 39.6% on ordinary income of $14m
  (iii) NJ tax: $6.28m at 8.97% on gain of $70m.
- SH recognizes no gain on the liquidation of S Corp to the extent of its stock basis.
- Since the SH is retaining more than 20%, The step-up benefit is not available due to the anti-churning rule.

**Post-deal structure:**

**Table:**

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<tr>
<th>Scenario</th>
<th>Scenario 1</th>
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<th>Scenario 3</th>
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SCENARIO 4

Purchase of 70% of an S corporation:

- Stock transaction
- Stock transaction with a Section 338(h)(10) election
- Asset transaction
- Partnership structure
SCENARIO 4: PURCHASE OF 70% OF NEW PARTNERSHIP

**Scenario 8**
1. SH forms New S Corp and transfers S Corp stock (“Old S Corp”) to New S Corp.
2. Old S Corp converts into an LLC. Steps 1 & 2 are treated as an F reorganization.
3. New S Corp distributes 1% of Old S Corp stock to SH
4. Buyer buys 70% of LLC interest from S Corp

**Tax implications:**
- SH recognizes gain on the 1% distribution, resulting in Fed CG tax of $0.2m at 20% on capital gain of $1m
- New S Corp recognizes gain on the sale of 70% LLC interest, resulting in:
  - (i) Fed CG: $11.2m at 20% on capital gain of $56m
  - (ii) Fed OI: $5.54m at 39.6% on ordinary income of $14m
  - (iii) NJ tax: $6.28m at 8.97% on gain of $70m
- S Corp status is preserved, and SH rolls over his 30% interest. Even though SH retains more than 20%, the anti-churning rule is avoided under this structure.
- The step-up benefit is available only to Buyer, and not to S Corp.

**Post-deal structure:**

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<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
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NPV of step-up ($70M over 15 yrs) to Buyer at 40% ETR and 10% discount rate
SCENARIO 4.1: PURCHASE OF 70% OF NEW PARTNERSHIP PLUS LEVERAGE

Scenario 8.1
1. SH drops down S Corp stock (“Old S Corp”) to New S Corp.
2. Old S Corp converts into an LLC. Steps 1&2 are treated as an F reorganization.
3. New S Corp distributes 1% of Old S Corp stock to SH.
4. Old S Corp borrows $30m from a bank and distributes the proceeds to SH and New S Corp.
5. Buyer buys 70% of LLC interest from S Corp for $49m cash.

Tax implications:
- SH recognizes gain on the 1% distribution, resulting in Fed CG tax of $0.2m at 20% on capital gain of $1m.
- New S Corp recognizes gain on the sale of 70% LLC interest ($49m cash and $21m relief of liability), resulting in:
  (i) Fed CG: $11.2m at 20% on capital gain of $56m
  (ii) Fed OI: $5.54m at 39.6% on ordinary income of $14m
  (iii) NJ tax: $6.28m at 8.97% on gain of $70m
- The tax implications are the same as Scenario 4, except SH receives additional proceeds of $9m which is not taxed as a debt-financed distribution.

Post-deal structure:

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NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate
SUMMARY AND OTHER CONSIDERATIONS
### SUMMARY OF SCENARIOS

#### 80% acquisition

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<th>Scenario</th>
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*NPV of step-up ($80m over 15 yrs) to buyer at 40% ETR and 10% discount rate

**Step-up benefit is split 80/20 between Buyer and S Corp absent remedial allocation.

#### 70% acquisition

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*NPV of step-up ($80m over 15 yrs) to Buyer at 40% ETR and 10% discount rate.
OTHER IMPORTANT CONSIDERATIONS

When negotiating a deal with the seller, the buyer should consider the following:

- Option to force the minority shareholder (the seller) to sell their interest upon the future sale of the 80/70% interest held by Buyer.
- Mechanism ensuring the sale proceeds, upon the future sale of the target interest, are prorated between the interest of Buyer and the interest of the minority shareholders. There should be no premium for the interest of the minority shareholder.
- Mechanism allowing tax distributions at 40% to both Buyer and the minority shareholder without taking into account special circumstances.
The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
ASC 740 DEVELOPMENTS

WILLIAM CONNOLLY
TAX MANAGING DIRECTOR, NATIONAL ASC 740 PRACTICE
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DANIEL NEWTON
TAX MANAGING DIRECTOR
DNEWTON@BDO.COM
ASU 2015-17 issued in November by the Board which requires deferred taxes to be shown as long term in a classified statement of financial position

► Transition method
  - The Board decided that entities should have a choice of applying the amendments either prospectively or retrospectively to all periods presented.

► Transition Disclosures
  - If an entity applies the amendments prospectively, the entity should disclose in the first interim and annual period of change (1) the nature of and reason for the change in accounting principle and (2) a statement that prior periods were not adjusted. If an entity applies the amendments retrospectively, the entity should disclose in the first interim and annual period of change (1) the nature of and reason for the change in accounting principle and (2) quantitative information about the effects of the accounting change to prior periods.
Effective Date and Early Adoption

- The Board affirmed the proposal that public business entities would be required to apply the amendments in annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual reporting periods.

- The Board affirmed the proposal that entities other than public business entities would be required to apply the amendments in annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

- The Board decided to allow earlier adoption for all entities as of the beginning of any interim or annual reporting period.
ASU 2016-09 IMPROVEMENTS TO EMPLOYEE SHARE-BASED ACCOUNTING

ASU 2016-09 issued on March 30, 2016

The changes as they relate to income taxes are as follows:

- Classify cash paid when directly withholding shares to meet statutory withholding requirements as a financing activity in the statement of cash flow.
  - Transition - Retrospective transition method (application of a different accounting principal to one or more previously issued financial statements).

- Removal of requirement to present excess tax benefits as a cash inflow from financing activities and a cash outflow from operating activities.
  - Transition - Either prospective or retrospective application of this provision is permitted.

- Board decided that all excess tax benefits and deficiencies be recognized within the income statement. Removes the requirement to recognize “excess tax” benefit until reduction of cash taxes.
  - Transition - modified retrospective method, with a cumulative-effect adjustment recognized in equity and prospective transition method for future excess benefits and deficiencies. All existing windfall benefits not recognized due to net operating losses are recognized.
Other Issues

- The ASU eliminates the requirement to defer recognition of an excess tax benefit until the benefit is realized through a reduction of taxes payable.

- Excess tax benefits and deficiencies are considered discrete items in the reporting period and are not included in the estimated effective tax rate.

- Excess tax benefits and deficiencies are excluded from the assumed proceeds available to repurchase shares in the computation of diluted earnings per share when an entity applies the treasury stock method.

- The tax impact of dividends on share-based payments will now be accounted for as income tax expense or benefit in the income statement rather than as an increase to APIC.
Effective date(s)

► Public business entities for fiscal periods beginning after December 15, 2016, including interim periods within those fiscal years

► Other entities for fiscal years beginning after December 15, 2017 and interim periods within fiscal years beginning after December 15, 2018

► Early adoption is permitted for:
  - Public business entities for reporting periods for which financial statements have not yet been issued
  - All other entities for reporting periods for which financial statements have not yet been made available for issuance

► An entity that elects to early adopt in an interim period shall reflect any adjustments as of the beginning of the annual period that includes that interim period
If early adopted all amendments must be adopted at the same time

Disclosures

In the period of adoption, entities are required to disclose:
- The nature and reason for the change in accounting principle
- The cumulative effects of the changes on retained earnings or other components of equity as of the date of adoption

Cash flows related to excess tax benefits disclose either:
- That prior periods have not been adjusted
  OR
- The effect of the change on prior periods retrospectively adjusted if the change is applied retrospectively
For changes in the statement of cash flows related to statutory tax withholding requirements, entities are required to disclose the effect of the change on prior periods retrospectively adjusted.
Other issues to consider

- **Valuation allowance**
  - Consider valuation allowance upon adoption
  - Release after adoption

- **Determination of the discrete item related to excess tax benefits**
  - Direct effect
  - Full ASC 740 “with and without”
  - Incremental effect

- **Existing APIC Pools**
  - No reclassification to retained earnings upon adoption
Early adoption other than first-quarter
- Must treat as if adopted at the beginning of the year
- Previously issued financials need to be recast in future filings (e.g. Form 10-Q, Form 10-K)

Accounting policy change for forfeitures will create additional deferred tax considerations
EXAMPLE OF SHARE-BASED PAYMENTS

Assume Fulham Co. grants a nonqualified stock option (NQSO)
- 40% rate
- Fair value at date of grant is $20 in 20x1
- Strike price equals market at date of grant - $30
- At date of exercise the fair value of the grant is $60

Fulham would recognize the following:

<table>
<thead>
<tr>
<th></th>
<th>Current guidance</th>
<th>New guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax payable</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Deferred tax expense</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Current tax benefit</td>
<td>(8)</td>
<td>(12)</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>(8)</td>
<td>(8)</td>
</tr>
<tr>
<td>APIC</td>
<td>(4)</td>
<td>-</td>
</tr>
</tbody>
</table>
EXAMPLE OF SHARE-BASED PAYMENTS

Assume the same facts as the previous example except the excess tax benefit recognized becomes part of an NOL carryover and Fulham will not record a valuation allowance with respect to its deferred tax assets.

Fulham would recognize the following:

<table>
<thead>
<tr>
<th></th>
<th>Current guidance</th>
<th>New guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred tax asset (NOL)</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>Deferred tax asset (stock comp)</td>
<td>(8)</td>
<td>(8)</td>
</tr>
<tr>
<td>Deferred tax benefit</td>
<td>-</td>
<td>(4)</td>
</tr>
</tbody>
</table>
INTRA-ENTITY ASSET TRANSFERS - ASU 2016-16

ASU 2016-16 was issued on October 24, 2016

- Requires that an entity recognize the income tax consequences of an intra-entity asset transfer, other than an intra-entity asset transfer of inventory, when the transfer occurs. For intra-entity asset transfers of inventory, the board decided to retain current GAAP, which requires an entity to recognize the income tax consequences when the inventory has been sold to an outside party.

- The Board decided that entities should apply the amendments on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.

- The Board affirmed the proposal that entities should disclose in the first annual period after adoption, and the interim periods within the first annual period, the nature of and reason for the change in accounting principle and certain quantitative information about the change in accounting principle.
The Board decided that public business entities should apply the amendments in annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods.

The board decided that entities other than public business entities should apply the amendments in annual reporting periods beginning after December 15, 2018, and interim periods in annual periods beginning after December 15, 2019.

The Board decided to permit early adoption for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance.

- That is, earlier adoption should be in the first interim period if an entity issues interim financial statements.
Assumptions:

- Widget Company, a U.S. Corporation, owns 100% of Guiness Co., an Irish entity. Widget and Guiness are included in a consolidated financial statement but file separate tax returns.

- Widget sells inventory to Guiness with a book and tax value of $50 for $100 which has not been sold by Guiness at the reporting date.

- Widget’s tax rate is 40% and Guiness’ tax rate is 12.5%.

Question:

- What entries should be recorded in the consolidated financial statements of the Widget/Guiness Group?
INTRA-ENTITY TRANSACTION EXAMPLE-CURRENT & PROSPECTIVE ACCOUNTING-INVENTORY

**Widget**
Dr A/R 100
  Cr Sale 100
Dr Cogs 50
  Cr Inventory 50
Dr Current tax Expense 20
  Cr Current tax Payable 20

**Guiness**
Dr Inventory 100
  Cr A/P 100

**Consolidation**
Dr A/P 100
Dr Sales 100
  Cr Inventory 50
  Cr Cogs 50
  Cr A/R 100
Dr Prepaid tax 20
  Cr Current tax Expense 20
INTRA-ENTITY TRANSACTION EXAMPLE-EXPOSURE DRAFT ACCOUNTING (REJECTED)-INVENTORY

Facts are the same as the previous example. Journal entries are as follows:

**Widget**
Dr A/R 100  
Cr Sale 100  
Dr Cogs 50  
Cr Inventory 50  
Dr Current tax Expense 20  
Cr Current Tax Payable 20

**Guiness**
Dr Inventory 100  
Cr A/P 100

**Consolidation**
Dr A/R 100  
Dr Sales 100  
Cr Inventory 50  
Cr Cogs 50  
Cr A/R 100  
Dr Deferred tax asset 6.25  
Cr Deferred Tax benefit 6.25

1. (50x12.5%)
Assumptions:

- Widget Company, a U.S. Corporation, owns 100% of Guiness Co., an Irish entity. Widget and Guiness are included in a consolidated financial statement but file separate tax returns.

- Widget sells intellectual property (IP) to Guiness for $100 which has a zero basis. Guiness is able to amortize the IP for tax purposes over a ten year period which approximates the estimated book life.

- Widget’s tax rate is 40% and Guiness’s tax rate is 12.5%

Question:

- What entries should be recorded in the consolidated financial statements of the Widget/Guiness Group with respect to the IP sale?
## INTRA-ENTITY TRANSACTION EXAMPLE - NON INVENTORY

### ASU 2016-16

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Widget</td>
<td>Dr A/R</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Cr Income</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Dr Current tax expense</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>Cr Current Tax payable</td>
<td>40</td>
</tr>
<tr>
<td>Guiness</td>
<td>Dr I.P</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Cr A/P</td>
<td>100</td>
</tr>
<tr>
<td>Consolidation</td>
<td>Dr Deferred tax asset</td>
<td>12.5</td>
</tr>
<tr>
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</table>

### Prior Accounting

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</table>
On July 26, 2016 the Board proposed an Accounting Standards Update, with a comment period of 60 days or ending on September 30, 2016, whichever is longer.

The Board decided to require prospective transition for all income tax disclosures.

Currently, some disclosure requirements in Topic 740, Income Taxes, are required of public entities and some are required of nonpublic entities. The Board decided to replace the term public entity with the term public business entity as defined in the Master Glossary of the Codification. The result is that some disclosures will be required of public business entities while other disclosures will be required of entities other than public business entities.
Disclose

- Income (loss) before income tax expense (benefit) disaggregated between domestic and foreign
- Income tax expense (or benefit) from continuing operations disaggregated between domestic and foreign shall be disclosed
- An explanation of circumstances that caused a change in assertion about the indefinite reinvestment of undistributed foreign earnings and the corresponding amount of these earnings
- The aggregate of cash, cash equivalents and marketable securities held by foreign subsidiaries
DISCLOSURE FRAMEWORK PROJECT-UNCERTAIN TAX POSITION DISCLOSURE - TENTATIVE DECISION

Disclose

- Settlements between cash and noncash items
- UTPs by balance sheet line item

Removes

- The disclosure of tax positions that could reasonably change within the next twelve months pursuant to ASC 740-10-50-15d
DISCLOSURE FRAMEWORK PROJECT- OTHER ASC 740 ISSUES

Disclose

- If a change in tax law has been enacted and it is probable that the change will affect the reporting entity in a future period
- Income taxes paid between domestic taxes paid and foreign taxes paid
- Foreign income taxes paid to any country that are significant relative to total income taxes paid
- The change in the valuation allowance and explaining the nature and amounts recorded or released during the reporting period (for public business entities only)
Rate Reconciliation - Public Business Entity

- Reconciliation between total income tax expense/(benefit) from continuing operations and PBT times the applicable statutory federal income tax rate showing the estimated reporting currency amount of each reconciling difference

- Should the public business entity be a foreign entity, the income tax rate in that entity’s country of domicile **shall normally** be used as the starting point of the reconciliation (emphasis added)
  - Different rates shall not be used for subsidiaries or other segments of the public business entity
  - If the rate used is other than the U.S. federal tax rate, the rate used and the basis for using that rate shall be disclosed

- If no individual reconciling item amounts to more than 5% of the computed amount and the total difference to be reconciled is < 5%, no reconciliation need be provided
Rate Reconciliation - Public Business Entity (cont’d)

- Reconciling items that are individually less than 5% of the computed amount may be aggregated in the reconciliation.
- The reconciliation may be presented in percentages or in the reporting currency.
- The statutory tax rates shall be the regular tax rates if there are alternative tax systems.
- Explanations of year-to-year changes in the reconciling items shall also be disclosed.
The amounts of federal, state, and foreign carryforwards (not tax effected) by time period of expiration for each of the first five years after the reporting date and a total of the amounts for the remaining years. (public business entities)

The deferred tax asset for carryforwards (tax effected) before valuation allowance disaggregated by federal, state, and foreign. Those amounts should be further disaggregated by time period of expiration for each of the first five years after the reporting date and a total of the amounts for the remaining years. (public business entities)

The total amount of unrecognized tax benefits that offset the deferred tax asset attributable to carryforwards

For entities other than public business entities the amounts of federal, state, and foreign carryforwards (not tax effected) should be disclosed.

The terms of any rights or privileges granted by a governmental entity directly to the reporting entity that have reduced, or may reduce, the entity's income tax burden. Does not apply to circumstances in which the entity meets the eligibility requirements that are broadly available to taxpayers without specific agreement between the entity and the government.
The Board’s presentation and disclosure project for Government Assistance Disclosures

- Applies to legally enforceable agreements with a government to receive value
- Does not apply to transactions in which the government is either
  - Legally required to provide a nondiscretionary level of assistance simply because the entity meets the eligibility requirement, or
  - Solely as a customer

Disclosure objectives

- Nature of assistance, related accounting policies, and effect on financial statement amounts
- Significant terms and conditions of the agreement

Exposure draft issued November 12, 2015

Comments were received in February 2016 and were very negative regarding the proposal

No effective date in the proposal but would apply to assistance existing as of the date of adoption as well as future assistance
At its June 8, 2016 meeting the Board:

- Reaffirmed the project will require guidance that is limited to disclosures.
- Reaffirmed that the scope will apply to an entity that has entered into a legally enforceable agreement with a government to receive cash, nonmonetary assets, or benefits that reduce or eliminate an entity’s expenditures. The Board directed the staff to perform further analysis about the types of nonmonetary assets that should be included within the scope of this project.
- Reaffirmed that not-for-profit entities will be excluded from the scope of this project.
- Decided to exclude from the project employee benefit plans.
- Decided to exclude from the project government assistance that is provided to an entity in the form of benefits that are available in determining taxable income or that are determined or limited on the basis of income tax liability, in accordance with Topic 740, Income Taxes.
Decided not to require the proposed disclosure about the amount of government assistance received but not recognized directly in the financial statements.

Decided that if an entity omits specific information required by the final Update because the information is legally prohibited from being disclosed, the entity should disclose a description of the general nature of the information omitted and the specific source of legal prohibition.

The Board will continue its redeliberations at a future meeting.
QUESTIONS AND WRAP-UP