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In This Issue:

Final GRA Regulations: A Mixed Bag

Old But Not Forgotten: Adjustments to Annual Layers of Pre-1987 Foreign Income Taxes

OECD Delivers Two New Discussion Drafts As Part of its Action Plan on Base Erosion and Profit Shifting

Notice 2014-58: Economic Substance Guidance Lacks Substance

Canadian Tax Update

Ready for Another Round? Michigan's Second Retroactive Repeal of the Multistate Tax Compact Election

A Real Game Changer?: *Temple-Inland v. Cook* and the Future of Unclaimed Property in Delaware

Baker & McKenzie Announces Three Important Seminar Opportunities in the Coming Months…

Final GRA Regulations: A Mixed Bag

On November 19, 2014, Treasury and the IRS issued final and temporary regulations under Code Sections 367 and 6038B regarding the consequences to US and foreign taxpayers of failing to file gain recognition agreements ("GRAs") or to comply with other reporting obligations in connection with certain transfers of property to foreign corporations in nonrecognition exchanges (the "Final Regulations"). 79 Fed. Reg. 68763; Treas. Reg. §§ 1.367(a)-2, 1.367(a)-3, 1.367(a)-3T, 1.367(a)-7, 1.367(a)-7T, 1.367(a)-8, 1.367(e)-2, 1.6038B-1. In general, the Final Regulations appear to be taxpayer favorable. A few key changes that merit attention are discussed below.

By way of background, the general rule in section 367(a)(1) provides that if a US taxpayer transfers property to a foreign corporation in any exchange described in Code Sections 332, 351, 354, 356, or 361, then the foreign corporation will not be considered to be a corporation for purposes of determining the extent to which gain is recognized on the transfer. Treas. Reg. § 1.367(a)-3 provides exceptions to the general rule for certain outbound transfers of stock or securities, including indirect stock transfers, by a US transferor. To avoid the recognition of gain on such transfers, the exceptions in some cases require the US transferor to comply with reporting requirements, including filing a GRA and other related documentation.

A GRA is an agreement pursuant to which a US transferor agrees to recognize gain if the transferee foreign corporation disposes of the transferred stock or securities during the term of the GRA and to pay interest on any additional tax owing if a so-called "triggering event" occurs. The GRA term is generally sixty months following the end of the taxable year in which the initial transfer is made. An example of a triggering event is a US transferor's failure to comply in any material respect with the terms of a GRA or any other reporting obligation imposed by the regulations. One such reporting requirement is that a US transferor file an annual certification with its timely-filed tax return for each of the five years covered by the GRA term. If the US transferor does not file the annual certification, then, under the Final Regulations, the transferor must recognize the full amount of gain realized on the initial transfer of stock or securities, unless it demonstrates that the "failure was not willful" (the "willful failure standard").

The willful failure standard is the new legal standard for purposes of obtaining gain recognition relief under the Final Regulations. It requires taxpayers to show only that the failure to comply with a reporting obligation was not willful, whereas the former standard required taxpayers to establish reasonable cause for the failure. The Final Regulations also extended the willful failure standard to other reporting obligations under section 367(a), including those in Treas. Reg. § 1.367(a)-2 (relating to outbound transfers of assets for use in the active conduct of a trade or business outside the US) and Treas. Reg. § 1.367(a)-7 (relating to outbound transfers of assets by a domestic target corporation in a section 361 exchange). Treasury and the IRS stated in the preamble to the Final Regulations that because the cases in which relief is sought under these provisions are also subject to the section 6038B reporting requirements (discussed below), "the penalty imposed under section 6038B for failure to satisfy a reporting obligation should generally be sufficient to encourage proper reporting and compliance." 79 Fed. Reg. 68765. The new willful failure standard is a win for taxpayers in that it imposes a lesser burden and should increase taxpayers' ability to obtain relief. But see Treas. Reg. § 1.6038B-1 (discussed below).

Under the Final Regulations, the term "willful" is "to be interpreted consistent with the meaning of that term in the context of other civil penalties, which would include a failure due to gross negligence, reckless disregard, or willful neglect." To obtain relief, the US transferor must, at the time that it discovers the failure, file an amended return for the taxable year to which the failure relates and include a written statement providing an explanation for the failure. The taxpayer must also file Form 8838 (Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement) with the amended return. Form 8838 operates to extend the statute of limitations on assessment to the later of (i) the close of the eighth full taxable year following the year of the initial transfer or (ii) the close of the third full taxable year ending after the date on which the taxpayer provides the required information to the Director of Field Operations International, LB&I (the "Director"). Finally, the taxpayer must comply with all other procedures set forth in Treas. Reg. § 1.367(a)-8(p). The determination of whether a failure to comply was willful will be made by the Director on the basis of all the facts and circumstances.

The examples in the Final Regulations shed light on how the IRS will apply the willful failure standard in practice. For instance, in Example 3 of Treas. Reg. § 1.367(a)-8(p)(3), a US taxpayer transferred stock to its wholly owned foreign corporation in a nonrecognition transaction. The US taxpayer timely filed its return for the year of the transfer and reported no gain on the transaction. Although the taxpayer was aware of its obligation under section 367(a)(1) to file a GRA that provided the basis and fair market value of the transferred stock, the taxpayer's GRA did not include the stock's fair market value and stated only that fair market value information was "available upon request." The example concludes that the taxpayer's GRA was not complete in all material respects and not timely filed. Of key importance, because the taxpayer "knowingly omitted" the fair market value information from the GRA, the taxpayer's omission was treated as a willful failure, and the taxpayer was ineligible for gain recognition relief under Treas. Reg. § 1.367(a)-8(p).

In cases in which a taxpayer files a GRA in connection with a transfer of stock or securities to a foreign corporation, section 6038B requires the taxpayer to also report certain information on Form 926 (Return by a US Transferor of Property to a Foreign Corporation) to avoid a penalty equal to ten percent of the transferred property's fair market value at the time of the exchange. The Final Regulations clarify that taxpayers must report on Form 926 the following information with respect to the transferred stock or securities: the fair market value, adjusted tax basis, gain recognized, and any other information specified in Form 926, its instructions, or other applicable guidance. The section 6038B regulations, however, preserve the reasonable cause standard with respect to failures to comply. That is, even if a US taxpayer establishes that its failure was not willful

Upcoming Tax Events:

State and Local Tax Roundtable
Palo Alto, California
January 7, 2015

2015 Annual North America Tax Workshop
San Diego, California
January 9, 2015

State and Local Tax Roundtable
Dallas, Texas
January 28, 2015

State and Local Tax Roundtable
Houston, Texas
January 29, 2015

European Tax Dispute Resolution Conference
Paris, France
February 5, 2015

Baker & McKenzie International VAT Conference
Amsterdam, Netherlands
March 13, 2015

16th Annual Latin American Tax Conference
Miami, Florida
March 17-19, 2015

Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference
Paris, France
March 30-31, 2015

Global Tax Planning and Transactions Workshop
New York, New York
April 29-30, 2015

under Treas. Reg. § 1.367(a)-8(p), the taxpayer remains subject to the ten-percent penalty under section 6038B unless it demonstrates that the failure was due to reasonable cause. See section 6038B(c)(2). This was a change from the proposed regulations (78 Fed. Reg. 6772), which included more limited filing requirements, and did not otherwise require taxpayers to provide any specific information for the transferred stock or securities. The expanded filing requirements tend to increase the compliance burden on taxpayers.

The Final Regulations also clarify that a taxpayer's failure to comply in any material respect with the GRA reporting requirements in Treas. Reg. § 1.367(a)-8 will extend the statute of limitations on assessment of tax for the taxable year in which gain is required to be reported until the close of the third taxable year ending after the date on which the US transferor provides to the Director any information that should have been reported under the regulations.

Finally, Treasury and the IRS extended gain recognition relief to taxpayer requests for relief filed before the effective date of the Final Regulations, including requests that were denied, if the statute of limitations on assessment for the year to which the request related has not expired and the US transferor resubmits the request under the procedures in Treas. Reg. § 1.367(a)-8(p). Treas. Reg. § 1.367(a)-8(r)(3). This retroactive relief is an apology of sorts for the withdrawal effective November 19, 2014, of the LMSB Directive on examination action with respect to certain GRAs (LMSB-4-0510-017 (July 26, 2010)) (the "Directive"). 79 Fed. Reg. 68765. Since 2010, the Directive had allowed taxpayers to cure unfiled or otherwise deficient GRA documents, such as an annual certification document, related to a timely filed initial GRA without demonstrating that the failure was due to reasonable cause. Although the Directive was intended to be temporary and taxpayers knew as much, its revocation will require taxpayers to be more vigilant in managing compliance with an array of reporting requirements.

The Final Regulations provide comprehensive guidance with respect to GRAs. Treasury and the IRS took strides to bring taxpayers within the compliance umbrella by moving to a willful failure standard and extending relief from gain recognition to requests filed before the effective date of the Final Regulations. These taxpayer wins were met with more expansive reporting obligations, which require taxpayers to report more specific data points in connection with certain outbound transfers of stock or securities. On balance, taxpayers that work with their tax departments to identify and comply with applicable requirements should have an easier time obtaining relief under the Final Regulations.

By Kristyn A. Medina, Washington DC

Old But Not Forgotten: Adjustments to Annual Layers of Pre-1987 Foreign Income Taxes

On October 31, 2014, the IRS released CCA 201444039, which provides that a US taxpayer has “no support in the Code, the regulations, or sound tax policy” for including an amount of foreign income taxes paid by its foreign subsidiary in such subsidiary’s post-1986 foreign income tax pool when the taxes relate to a year prior to the ownership requirements of Code Section 902(c)(3)(B) being satisfied. In its request for guidance, the taxpayer argued that foreign taxes paid more than two years after the year to which the taxes relate must be taken into account in the year the tax is actually paid, even though none of the earnings to which the taxes relate are included in its post-1986 undistributed earnings pool. The IRS determined that the taxpayer erred in its application of the law and should have applied the law as in effect prior to the effective date of the Tax Reform Act of 1986.

In 2009, US corporation (USP), a parent of a US affiliated group, acquired all the shares of a foreign corporation (FP). At the time of the acquisition, FP owned all of the shares of foreign corporation 3 (FC3), which in turn owned all the shares of foreign corporation 4 (FC4). As a result, FP, FC3, and FC4 became CFCs in 2009.

Between 2008 and 2011, FC4 was assessed additional income taxes and interest by its home jurisdiction in relation to tax years 1994 through 2008. FC4 was actively contesting the tax assessments but was required to pay 50% of the total tax assessments during years 2008 through 2011. In 2010, USP recognized a deemed dividend inclusion from FC4 and claimed a foreign tax credit, which included a portion of the foreign income tax assessments relating to years prior to FC4 becoming a CFC.

Law and Analysis

To claim a deemed paid foreign income tax credit, a domestic corporation must satisfy the section 902(c)(3)(B) ownership requirements with respect to a foreign corporation and properly track such foreign corporation’s earnings and foreign income taxes paid or accrued. Section 902 and the Regulations issued thereunder require that undistributed earnings and foreign income taxes be separated into two categories: post-1986 undistributed earnings and foreign income tax pools and pre-1987 undistributed earnings and foreign income tax pools (including annual layers within the pre-1987 pool). Generally, a foreign corporation’s post-1986 foreign income tax pool includes foreign income taxes relating to tax years beginning after December 31, 1986. However, if the first day on which the foreign corporation satisfies the ownership requirements of section 902(c)(3)(B) is after December 31, 1986, the foreign corporation’s post-1986 foreign income tax pool begins on the first day of the taxable year in which such ownership requirements are met. In the ruling, FC4 was acquired by USP in 2009 and therefore, its post-1986 foreign income taxes were established beginning on January 1, 2009, which is the first year FC4 had a domestic shareholder entitled to compute an amount of foreign taxes deemed paid under section 902.

Section 902(c)(6) provides that distributions out of accumulated profits for taxable years beginning before the first taxable year taken into account in determining the post-1986 undistributed earnings are governed by section 902 as in effect before the enactment of the Tax Reform Act of 1986. From an ordering perspective, dividends paid after December 31, 1986 are treated as being made first out of the post-1986 undistributed earnings to the extent thereof and any excess is then treated as being made out of pre-1987 undistributed earnings on a last in, first out ("LIFO") basis.

In 2010, USP recognized an income inclusion and computed its deemed paid foreign tax credit under section 902 (as provided for by Code Section 960). In the ruling request, the taxpayer unsuccessfully argued that Code Section 905(c) and the Regulations thereunder (which address foreign tax redeterminations) should apply with respect to the foreign income taxes paid in 2009. The taxpayer argued that the additional tax assessment with respect to 2002 paid in 2009 should increase FC4’s post-1986 foreign income taxes because the taxes were paid more than two years after the year to which the taxes relate. Thus, the taxpayer argued for an increase in FC4’s post-1986 foreign income tax pool for taxes relating to a year prior to meeting the ownership requirements under section 902(c)(3)(B).

The IRS rejected taxpayer’s argument pointing out that section 905(c), and the Regulations thereunder, were revised in 1997 by the Taxpayer Relief Act and do not apply to section 902 computations relating to pre-1987 foreign income tax pools. The IRS stated that section 902(c) expressly provides that the law in effect prior to the effective date of the Tax Reform Act of 1986 applies. The IRS further emphasized that, even if one were to disregard the position expressly set out in section 902(c) and the Regulations under that section, the taxpayer’s position is expressly contradicted by the section 905(c) temporary regulations in effect for 2008, 2009 and almost all of 2010. Moreover, the IRS expressly provided that the adjustment to pre-1987 undistributed earnings and foreign income taxes is consistent with the purpose of the foreign tax credit regime to alleviate double taxation of foreign source income. To rule otherwise, the IRS believed, “in addition to being squarely contradicted by the statutory and regulatory regime, is flatly inconsistent with the Congressional policy underlying the matching regime established by [S]ection 902.”

Accordingly, the IRS concluded that the foreign income taxes relating to taxable years 1994 through 2008, although paid in a post-1986 year, should be accounted for by adjusting the foreign corporation’s annual layer of pre-1987 foreign income taxes for the appropriate year.

By Rodney W. Read, Houston

OECD Delivers Two New Discussion Drafts As Part of its Action Plan on Base Erosion and Profit Shifting

In July 2013, the OECD and G20 countries adopted a 15-point Action Plan on Base Erosion and Profit Shifting (“BEPS”). The first set of Action Plan components were released in September and discussed in a prior edition of this newsletter. See prior Tax News and Developments article *OECD Delivers First Seven Components of its Action Plan on Base Erosion and Profit Shifting (BEPS)*, (Vol. 14, Issue 5, October 2014) located under publications at www.bakermckenzie.com. The OECD recently released two additional discussion drafts for public comment regarding Action 7 and Action 10 (“Discussion Drafts”):

- The Action 7 Discussion Draft (Preventing the Artificial Avoidance of PE Status) was issued on October 31, 2014, asking for public comments by January 9, 2015; and

- The Action 10 Discussion Draft (Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines Relating to Low Value-Adding Intra-Group Services) was issued on November 3, 2014, asking for public comments by January 14, 2015.

Below, is a summary of key points from each of the two Discussion Drafts.

Action 7

The Discussion Draft for Action 7 proposes changes to the OECD Model Tax Convention (“Model Convention”) definition of Permanent Establishment (“PE”). The Discussion Draft proposes a series of potential changes to the Model Convention and offers multiple options for specific language/policy changes to address artificial PE avoidance. The Discussion Draft focuses on the following areas:

- Commissionaire Arrangements
- Specific Activity Exemptions
- Contract Splits
- Insurance
- Income Attribution/Transfer Pricing

Commissionaire Arrangements

The OECD asserts that commissionaire arrangements have been put in place primarily to erode the taxable base of the country in which sales take place, thus improperly shifting income. A commissionaire arrangement allows an enterprise, the commissionaire, to sell products in a State in its own name but on behalf of a foreign enterprise that is the owner of the products. The foreign enterprise is generally able to avoid a PE because it is not concluding contracts in the State; rather, the commissionaire is selling the product and concluding the contract in its own name. The commissionaire enterprise earns a service commission from the foreign enterprise for its sales activities, which is taxed in the State. According to the OECD, the service commission earned by a commissionaire generally results in a smaller taxable profit than a distributor would earn for conducting similar activities.

The Discussion Draft maintains that commissionaire arrangements create a tax nexus via the contract formation activities of an intermediary (unless the intermediary in question is acting as an independent business) that will be fulfilled by a foreign enterprise. The Discussion Draft proposes the following potential revisions to the PE provision, to allow the State to tax the foreign enterprise in commissionaire and similar arrangements.

A. Option A replaces the requirement found in Article 5, Paragraph 6 of the Model Convention that a dependent agent must “conclude contracts” on behalf of a foreign enterprise to establish a PE, to instead require activities that “[result] in the conclusion of contracts.” Under Option A, a taxpayer would establish a PE when there is repeat engagement that leads to the conclusion of contracts in the name of, or the provision of property/services by, the foreign enterprise. Option A would also narrow the circumstances under which an intermediary would be treated as an independent agent by treating a person that acts exclusively or almost exclusively on behalf of one foreign enterprise as a dependent agent of the foreign enterprise.

B. Option B is similar to Option A but it addresses situations where contracts are not formally concluded by the person who is acting on behalf of the foreign enterprise. Thus, Option B provides that a dependent agent would establish a PE on behalf of an enterprise where it either “concludes contracts, or negotiates the material elements of contracts” in a Contracting State. Option B also tightens the requirements for independent agent status, as discussed in Option A.

C. Option C shifts the focus from “contracts in the name of the enterprise” to include consideration of the legal relationship and risk of the foreign enterprise, in determining whether a PE exists. Thus, Option C provides that a dependent agent would establish a PE on behalf of an enterprise where it “habitually engages with specific persons in a way that results in the conclusion of contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise.” in a Contracting State. Option C also tightens the requirements for independence as discussed in Option A.

D. Option D is a combination of Option B and Option C, and considers the elements of the contract negotiations, the legal relationship, and risk in determining whether a PE exists. Thus, Option D provides that a dependent agent would establish a PE on behalf of an enterprise where it either: (i) habitually concludes contracts or (ii) negotiates the material elements of contracts, which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise. Option D also tightens the requirements for independence as discussed in Option A.

Specific Activity Exemptions

Article 5(6) of the Model Convention provides that activities that are merely “preparatory and auxiliary” will not rise to the level of a PE, and includes a list of specific, exempt activities that are treated per se as “preparatory or auxiliary activities,” regardless of their scope The Discussion Draft considers the use of the exempt activity categories to conduct substantial activities in a foreign jurisdiction--specifically, large-scale warehousing, purchasing and information gathering activities--as artificially avoiding a PE. The Discussion Draft proposes the following changes to correct this perceived problem.

E. Option E expressly limits the specific activity exemptions only to activities in those categories that are in fact preparatory or auxiliary.

F. If Option E is not adopted, Option F would remove specific activity exemptions for the delivery of goods. Of particular concern to the OECD is the use of the specific activity exemptions for an enterprise that sells goods online but maintains a large warehouse and delivery operation in the State. The Discussion Draft also addresses the artificial fragmentation of cohesive business activities to create multiple, related entities conducting merely "preparatory or auxiliary activities," thereby avoiding the formation of a PE.

G. If Option E is not adopted, Option G would remove the exception for purchasing goods for an enterprise. The Discussion Draft discusses as examples of perceived abuse purchasing offices acting as the sole acquirer of related enterprise products and purchasing offices performing valuable services by expertly sourcing agriculture products from a number of small producers for export.

H. As an alternative to Option G, Option H would remove specific activity exemptions relating to a presence for the purchase of goods or the collection of information. The Discussion Draft raises concerns that the collection of information exception allows the repackaging of information into reports provided to other enterprises.

The Discussion Draft also addresses the artificial fragmentation of cohesive business activities to create multiple, related entities conducting merely "preparatory or auxiliary activities," thereby avoiding the formation of a PE. The Discussion Draft proposes the following changes below to address this issue.

I. Option I limits the ability of associated enterprises in the same State to distribute cohesive business activities among themselves to avoid a PE, if at least one of the associated enterprises has a PE in the State and the activities of the other enterprises constitute complementary functions that are part of the same cohesive business operation.

J. Option J is a variation of Option I. It extends the limitation on the distribution of cohesive business activities to situations where none of the associated enterprises in the State would independently constitute a PE, but the combined activities of the associated enterprises are more than preparatory or auxiliary.

Contract Splits

Article 5(3) of the Model Convention provides that a building site or construction or installation project lasting 12 months or less will not constitute a PE. The Discussion Draft raises specific concerns that this provision can be abused by splitting-up contracts to avoid the 12-month threshold, particularly in the context of construction projects and other service projects. The Discussion Draft seeks to limit artificially structuring contracts to fall below the 12-month threshold by splitting the contract among related enterprises. The Discussion Draft acknowledges that such abuse often would be covered by anti-avoidance rules but proposes the following options below.

K. Option K imposes an "automatic approach" to include the time spent by associated enterprises at the same site in determining whether a PE is formed.

L. Option L does not add a specific rule but instead relies on the general anti-avoidance rule proposed as part of the work on Action Item 6, and also adds a relevant example to the general anti-abuse rule.

Insurance

The Discussion Draft seeks to address situations where insurance companies may have extensive business activities in a State without having a PE through the use of local independent agents or dependent agents that do not have the ability to conclude contracts. Specifically, the Discussion Draft considers when the activities of insurance agents or brokers should be sufficient to establish a PE even if they do not conclude contracts for their principal. The Discussion Draft provides the following options below to address this perceived abuse.

M. Option M deems that a PE shall exists (except in regard to reinsurance) when the insurance enterprise collects insurance premiums or insures risks in the State through a person other than an agent of independent status.

N. Option N relies on Options A and D to capture the activities of insurance companies that could create a PE. Options A and D reflect a shift away from focusing on the conclusion of contracts to determine PE to instead considering a wider range of activities and surrounding facts related to the conclusion of a contract.

Income Attribution/Transfer Pricing

The OECD acknowledges its continuing challenges in addressing the attribution of income to PEs and the need to coordinate with the work done on other elements of the BEPS Action Plan. Specifically, the Discussion Draft notes that the OECD is still determining whether substantial changes need to be made to the PE-related profit attribution rules, but that conclusions reached with respect to other elements of the BEPS Action Plan may result in substantial changes to the profits allocated to a PE.

Action 10

The recently-released Discussion Draft for Action 10 only addresses part of Action 10. The original Action 10 in the OECD's BEPS Action Plan called for:

> "adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing method, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses."

The Discussion Draft only addresses item (iii) of Action 10. The OECD proposes that this Discussion Draft will replace the full text of Chapter VII of the OECD Transfer Pricing Guidelines, as modified following comments and consensus.

The main updates to the OECD's chapter on services transactions involve:

- Adding the concept of low value-adding intra-group services (or "Low-Value Services");
- Broadening and clarifying the definition of shareholder activities; and
- Updating example language for contract manufacturing and research services.

Low-Value Services

The definition of Low-Value Services is similar to the definition of services qualifying for the Services Cost Method in the US Treasury Regulations. The OECD provides that Low-Value Services are those that are supportive, not part of the core business of the company, do not use or create valuable intangibles, and do not involve the control of or creation of significant risk. Similar to the US Treasury Regulations, the Discussion Draft provides a "blacklist" of services which cannot qualify as Low-Value Services, specifically:

- Services constituting the core business of the MNE group;
- Research and development services;
- Manufacturing and production services;
- Sales, marketing and distribution activities;
- Financial transactions;
- Extraction, exploration, or processing of natural resources;
- Insurance and reinsurance; and
- Services of corporate senior management.

Examples of types of services which would likely meet the definition of Low-Value Services are provided, but not a specific "whitelist." The examples include accounting; accounts receivable and payable; human resources; health, safety, and environmental; information technology; public relations; legal; tax; and other general clerical services.

The Discussion Draft specifies the steps in determining charges for Low-Value Services. First, determine a cost pool of Low-Value Services incurred by all entities of a MNE, excluding costs an entity incurs for performing services on its own behalf or direct costs for performing services for another entity. Second, determine reasonable allocation key(s) to allocate the pooled costs. Third, apply a single markup between 2% and 5% to all Low-Value Services.

A less burdensome benefits test is introduced for Low-Value Services than for services transactions in general, with the objective of mitigating the non-deductibility of management fees in recipient countries. The Discussion Draft states that "tax administrations should consider benefits only by *categories of services* and not on a *specific charge basis*." The taxpayer is not "required to specify individual acts undertaken that give rise to the costs charged." Therefore, with respect to Low-Value Services that benefit multiple entities, the intention is that recipient country tax authorities should not demand unreasonable detail in supporting why the services benefited entities in the recipient country.

Instead, the Discussion Draft adds specific documentation requirements that would, when met, constitute sufficient detail. Specifically, the documentation must include descriptions of the Low-Value Services, justification for why they qualify as Low-Value Services, calculation of the cost pool and identification of direct costs, and an application of specified allocation keys. Documentation meeting these requirements should constitute sufficient support for the recipient country tax authorities' to allow management fee expense deductions.

Definition of Shareholder Activities

The definition of shareholder activities is broadened and clarified, and now comprises the following activities:

a) Costs relating to shareholder meetings, stock exchange listings, or the company's board;

b) Costs relating to reporting requirements (including audit fees) of the parent company;

c) Costs of raising funds and costs of investor relations and dealing with other stakeholders;

d) Costs relating to compliance of the parent company with the relevant tax laws; and

e) Costs ancillary to the corporate governance of the MNE as a whole.

The 2010 OECD Guidelines did not explicitly identify parent company audit, tax, or investor relations as being shareholder activities. This Discussion Draft seeks to clarify that these activities are indeed shareholder activities, as well as provide for the common situation that group entities other than the parent may perform shareholder activities, and the appropriate transfer price for these shareholder services should be charged to the shareholder accordingly.

Updates to Examples

The section on examples of intra-group services is updated with new language regarding contract manufacturing and contract research services, stepping back from the 2010 OECD Guidelines' broad generalizations regarding these types of services in favor of a more facts-and-circumstances approach to assessing whether a manufacturing activity should be compensated via a cost plus arrangement or whether another method should be used.

By Steven Hadjilogiou, Miami, Eric Torrey, Washington, DC,
Omair M. Khan* and *Andrew C. O'Brien-Penney, Chicago

Notice 2014-58: Economic Substance Guidance Lacks Substance

In an unexpected move, the IRS issued Notice 2014-58 in an attempt to provide taxpayers with much needed guidance on the application of the economic substance doctrine ("ESD") in Code Section 7701(o). While taxpayers have been pleading for guidance on this ambiguous provision, the Notice unfortunately creates more questions than it answers.

The Notice resolves when penalties apply to transactions that lack economic substance; however, the Notice's insufficient attempt to delineate the "transaction" to which the economic substance doctrine applies creates more questions than it answers.

Similar Rule of Law

Pursuant to section 7701(o), a transaction has economic substance when (1) the transaction changes the taxpayer's economic position and (2) the taxpayer has a substantial non-tax purpose for entering into the transaction. In addition, Code Section 6662(b)(6) imposes a 20 percent penalty on the tax underpayment related to any transaction that lacks economic substance or fails to meet the requirements of "any similar rule of law." The penalty is increased to 40 percent if a taxpayer does not properly disclose the transaction, and most importantly, a taxpayer cannot rely on the reasonable cause exception to reduce a section 6662(b)(6) penalty. Understandably, the ambiguity of the phrase "any similar rule of law" left many taxpayers fearful as to whether a transaction that lacked "substance" under the step-transaction or substance-over-form doctrines would also be subject to the harsh provisions of section 6662(b)(6).

The Notice provides that the IRS will only assert section 6662(b)(6) penalties when it applies the two-factor analysis in section 7701(o). Thus, the IRS will not apply the section 6662(b)(6) penalty when it relies on the substance-over-form or step-transaction doctrines to recharacterize a transaction.

Defining the Transaction

Any gratitude that taxpayers felt towards the IRS for its clarification of section 6662(b)(6) was quickly extinguished when the IRS "clarified" how it intends to determine a taxpayer's "transaction" for purposes of applying the economic substance doctrine. As noted above, section 7701(o) provides that a "transaction" has economic substance as long as the "transaction" changes in a meaningful way the taxpayer's economic position and the taxpayer has a substantial purpose for entering into the "transaction." Thus, every practitioner knows that one of the keys to winning an ESD dispute is to define the scope of a "transaction" in the most favorable manner.

Regrettably, rather than providing taxpayers or courts with any real guidance as to how the IRS will define the scope of a transaction, the Notice provides that the IRS will define the scope of a transaction based on "facts and circumstances" (i.e., the IRS believes it is free to define the transaction however it wants). Accordingly, the IRS can aggregate a series of "interconnected" transactions so that the IRS applies the ESD to the combined transactions (the "aggregation approach"); on the other hand, the IRS can also disaggregate a single transaction so that the IRS applies the ESD to a “tax-motivated” step within the transaction that is not necessary to accomplish non-tax goals (the “disaggregation approach”).

The disaggregation approach is based on the holding in *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). In essence, it allows the IRS to bifurcate a transaction such that the tax-motivated step is separated from the other steps that give the overall transaction a business purpose.

If the courts had always been allowed to disaggregate a transaction in this manner, many taxpayer favorable ESD cases may have had different outcomes. For example, in *Flextronics America v. Commissioner*, 499 Fed. Appx. 725 (9th Cir. 2012), the taxpayer transferred the same asset several times among its various subsidiaries in order to get a non-taxable basis increase and “to set up its desired operating structure.” If the court had applied the disaggregation approach in *Flextronics*, the court may have applied the ESD to the transfer that provided the basis increase and not to the other transfers that allowed the corporation to establish its operating structure. Similarly, the outcome in *Shell Petroleum Inc. v. United States*, 102 A.F.T.R.2d 5085 (S.D. Tex. 2008) may also have been different. In that case, the taxpayer contributed multiple assets and liabilities to a new entity as part of the same transaction. If the court had applied the disaggregation approach, the court would have analyzed whether each transfer of assets had a valid business purpose. Accordingly, the court may have applied the ESD to the transfer of one of the assets and not to the transfers of the other assets (even though all the transfers were part of the same transaction).

In addition, the IRS’s characterization of the aggregation approach could create headaches for taxpayers. The Notice provides that a series of transactions can be aggregated if the transactions are “interconnected.” In many instances, taxpayers will want to argue that the aggregation approach applies because it is often easier to satisfy the two ESD factors under the aggregation approach. However, by arguing that the more taxpayer-friendly aggregation approach applies to a transaction, a taxpayer may be shooting itself in the foot for step-transaction doctrine purposes. If the step-transaction doctrine also could apply to a transaction, then the taxpayer would have to argue that a series of transactions are “interconnected” for ESD purposes while also arguing that the transactions are not “interdependent” for step-transaction purposes.

Ultimately, the IRS’s approach to defining “transaction” seems to be saying to taxpayers “heads I win, tails you lose.”

The House Report

The Notice also represents the first time that the IRS has referred to The House Ways and Means Report 111-443 (the “House Report”) as legislative history. A great deal of uncertainty exists as to whether the House Report is authoritative legislative history because the House Report was written to accompany a bill that never became law.

While the House Report may create issues for taxpayers (after all, the IRS relied on it as authority for the disaggregation approach), the House Report is enormously helpful to taxpayers in other ways. In particular, the House Report lists four kinds of transactions to which the ESD does not apply. The House Report provides:

> [Section 7701(o)] is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a US person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

This so called "Angel's List" has been very helpful to taxpayers that are attempting to understand when the ESD is relevant to a transaction. Taxpayers who have been relying on the Angel's List should find comfort in the fact that the IRS views the House Report as authoritative legislative history.

By John D. Barlow, Washington, DC

Canadian Tax Update

The following is an update of current Canadian tax matters that may be of interest to corporate groups with Canadian members:

New Back-to-Back Loan Rules in effect on January 1, 2015

The Canadian Government released revised "back-to-back" loan rules on October 23rd. The back-to-back loan rules are meant to address situations in which indirect arrangements are used to avoid the application of the Canadian withholding tax rules applicable to interest payments and/or the application of the Canadian "thin capitalization" rules. The back-to-back loan rules are proposed to apply, with respect to Canadian withholding tax, to amounts paid or credited after 2014, and with respect to the Canadian thin capitalization rules, with respect to taxation years that begin after 2014. Multinational groups with Canadian members should review existing debt financing arrangements involving Canadian group members to determine whether the back-to-back loan rules could apply and, if so, whether changes to existing arrangements are required.

A brief description of the Canadian withholding tax rules applicable to interest payments, the Canadian thin capitalization rules and the application of the back-to-back loan rules is below.

The *Income Tax Act* (Canada) (the "ITA") imposes a 25% withholding tax on interest paid by a Canadian resident to a non-resident if (i) the non-resident does not deal at arm's length with the Canadian resident payer; or (ii) the interest is "participating debt interest". This 25% rate may be reduced, typically to 10%, if the recipient is entitled to the benefits of a tax treaty between Canada and the country in which the recipient is fiscally resident. The Canada-US Tax Convention generally eliminates withholding tax in respect of all interest, other than participating interest.

The ITA also contains “thin capitalization” rules that may limit the deductibility of interest paid by a Canadian corporation (and certain other entities) to a non-Canadian group member if the amount of debt owing by the Canadian corporation to non-Canadian group members exceeds 150% of the Canadian corporation’s equity. The non-deductible interest is treated as a dividend (not interest) for Canadian withholding tax purposes.

In the absence of anti-avoidance rules, the Canadian withholding tax rules applicable to interest and the Canadian thin capitalization rules could be circumvented through the use of an intermediary to make loans to the Canadian debtor. For example, a non-Canadian parent company (“Forco”) might make a loan to an arm’s length intermediary on condition that the intermediary make a loan to Forco’s Canadian subsidiary (“Canco”). Such an arrangement may have the objective of (i) reducing/eliminating the Canadian withholding tax that would otherwise have applied if the interest payments had been made directly by Canco to Forco; and/or (ii) excluding the debt owing by Canco to the intermediary from the application of the Canadian thin capitalization rules. However, if the back-to-back loan rules apply, the Canadian debtor (i) may be deemed to pay some or all of the interest to the underlying creditor (and not to the intermediary) for Canadian withholding tax purposes, thus increasing the Canadian withholding tax applicable to the interest; and (ii) may be deemed to owe some or all of the debt to the underlying creditor (and not to the intermediary) for purposes of the thin capitalization rules.

Very generally speaking, the back-to-back loan rules may apply, in the context of Canadian withholding tax on interest, to arrangements in which a reduced withholding tax rate would otherwise be available in respect of interest paid or credited by the Canadian entity to an intermediary and:

(i) a loan has been made by a non-resident of Canada to the intermediary and recourse in respect of the loan to the intermediary is limited to the debt owing by the Canadian entity to the intermediary;

(ii) a loan has been made by a non-resident to the intermediary and it can reasonably be concluded that the loan made by the intermediary to the Canadian entity was made because of the loan to the intermediary; or

(iii) the intermediary has been granted a “specified right” by a non-resident member of the Canadian entity’s group in respect of the Canadian entity’s debt to the intermediary (a specified right in respect of a property is a right to mortgage, hypothecate, assign, pledge or encumber the property to secure payment or a right to use, invest, sell or dispose of the property).

Similar rules apply in the context of the Canadian thin capitalization rules.

Anti-Treaty Shopping Proposal on Hold

The Canadian Government proposed a domestic anti-treaty shopping rule in its 2014 Budget. This anti-treaty shopping rule provided that a treaty benefit would not be provided in respect of an amount of income, profit or gain if it is reasonable to conclude that one of the main purposes for undertaking a transaction is to obtain the benefit of the treaty. The Canadian Government has now announced that it has decided that rather than advancing the domestic treaty shopping initiative at this time, it will instead await further work by the OECD and the Group of 20 (G-20) in relation to the their Base Erosion and Profit Shifting (“BEPS”) initiative.

Don’t Forget to File…the GST/HST Section 156 Election

Certain closely related corporations and partnerships are able to make a joint election under section 156 of the Excise Tax Act (Canada) (the “ETA”) that generally deems supplies of property and services between them to be made for nil consideration. As a result, while the election is in effect, goods and services tax/harmonized sales tax (“GST/HST”) will generally not apply to intercompany supplies between them. Corporations and partnerships contemplating the election must be resident in Canada, registered for GST/HST purposes, engaged exclusively (90% or more) in commercial activities (i.e., taxable activities) and meet a 90% common ownership test.

Currently, the parties do not have to file the election with the Canada Revenue Agency (the “CRA”). Rather, the electing parties must retain copies of the election form on file in the event of audit. However, as announced in the February 2014 Budget, and pursuant to amendments to the ETA which received Royal Assent on June 19, 2014, parties to a new section 156 election made on or after January 1, 2015 will be required to file a new election form RC4616 with the CRA by the earliest date on which any of the parties to the election is required to file a GST/HST return for the period that includes the day on which the election becomes effective.

A filing requirement will also apply for section 156 elections made prior to January 1, 2015. These existing elections will only remain in effect for intercompany supplies made on or after January 1, 2015 if the parties file Form RC4616 with the CRA between January 1, 2015 and December 31, 2015. In addition to the filing requirements, the amendments to the ETA also provide that electing parties will be jointly and severally, or solidarily, liable with respect to GST/HST liability that may arise in relation to supplies made between them on or after January 1, 2015. As a result of the filing of this election in 2015, the CRA will become aware of registrants who have previously relied on the election and not charged GST/HST on intercompany supplies in the past. GST/HST registrants who have made the election before 2015 are encouraged to ensure that the conditions for making the election were satisfied at the time the election was made and continue to be satisfied. GST/HST registrants are also encouraged to note their section 156 election filing obligation in their 2015 calendar.

Time Runs Out on January 1, 2015 if your Real Estate Joint Venture Operator is a Bare Trust or Nominee Corporation

A joint venture is not considered to be a “person” for GST/HST purposes and therefore cannot register and account for GST/HST in its own right. In the absence of the election discussed below, each co-venturer would have to separately account for and report its proportionate share of the joint venture’s GST/HST.

However, section 273 of the ETA allows co-venturers in certain types of joint ventures to simplify their GST/HST accounting obligations by electing to have a “participant” in the joint venture act as the “operator” and assume responsibility for the joint venture’s GST/HST accounting obligations. If the co-venturers make the election, the joint venture is treated as if it were a “person” and effectively files its own GST/HST returns through the operator, thus easing the compliance burden of the co-venturers.

The term “participant” is not defined in the ETA. Unfortunately, the CRA interprets “participant” narrowly for purposes of the joint venture election, as:

(a) a person who, under a joint venture agreement evidenced in writing, makes an investment by contributing resources and takes a proportionate share of any revenue or incurs a proportionate share of the losses from the joint venture activities; or

(b) a person, without a financial interest, who is designated as the operator of the joint venture under an agreement in writing and is responsible for the managerial or operational control of the joint venture.

Therefore, if a person does not contribute resources to the joint venture, it must have managerial or operational control of the joint venture to be a “participant”. Moreover, the CRA has taken the position that a person must have authority to manage the joint venture’s daily activities without requiring input from or the approval of the other participants in order to have managerial and operational control of the joint venture.

This narrow interpretation has created problems, particularly for the real estate industry, where legal title to a joint venture’s property is frequently held by a bare trust or nominee corporation, without independent powers, discretion or responsibilities. Notwithstanding the CRA’s narrow interpretation, it is not uncommon for co-venturers to make the joint venture election and appoint the bare trust or nominee corporation as the joint venture operator who accounts for GST/HST on behalf of the joint venture even though it would not be eligible according to the CRA.

Bare trusts and nominee corporations acting as operators may have exposure for input tax credits incorrectly claimed and individual co-venturers may have exposure for GST/HST not collected in respect of supplies made by the joint venture.

However, the CRA announced earlier this year that it would exercise administrative tolerance and not assess joint ventures whose operators are bare trusts or nominee corporations for reporting periods ending before January 1, 2015 as long as all returns have been filed, all amounts have been remitted and the joint venture participants are otherwise fully compliant.

However, the CRA indicated that its auditors will once again be free to assess joint venture operators and co-venturers where a joint venture operator does not meet the CRA's interpretation of "participant" in reporting periods commencing on or after January 1, 2015.

Real estate co-venturers who have made the GST/HST joint venture election are strongly encouraged to ensure that the operator of the joint venture qualifies as a "participant" for purposes of the election and, if not, should appoint a joint venture operator that meets either the investment or managerial and operational control criteria. In considering the operator's eligibility, it is worth noting that the CRA recognizes that the terms "nominee corporation" and "bare trust" may be used somewhat loosely by businesses. As a result, it is possible that a so-called nominee corporation or bare trust may, in fact, have a sufficient level of power and authority to meet the CRA criteria to be a "participant".

By Alex Pankratz and Randy Schwartz, Toronto

Ready for Another Round? Michigan's Second Retroactive Repeal of the Multistate Tax Compact Election

The retroactive legislation enacted in response to *IBM v. Department of Treasury* is now being examined by the Michigan courts. On July 14, 2014, the Michigan Supreme Court ruled in favor of the taxpayer in IBM, holding that IBM was entitled to elect the Multistate Tax Compact's ("MTC" or the "Compact") three-factor apportionment formula under the Michigan Business Tax Act ("MBT") instead of the single sales factor apportionment formula provided by the MBT for tax year ending 2008. Electing to use the MTC formula instead of the single sales factor formula can benefit many out-of-state taxpayers by permitting them to dilute their sales factor with a lower property and payroll factor. In fact, the Michigan Senate Fiscal Agency estimated that the Michigan Department of Treasury (the "Department") would potentially owe tax refunds of $1.09 billion plus interest to taxpayers electing to use the MTC formula for tax years January 1, 2008 through December 31, 2010. In an attempt to limit the impact of IBM, the Michigan legislature retroactively repealed the MTC Compact in its entirety, including the MTC election, effective January 1, 2008 (Public Act 282 of 2014, effective September 12, 2014). For background information on Michigan's retroactive repeal of the MTC, see prior *Tax News and Developments* article *Never a Dull Moment…Michigan Seeks to Re-Write History By Retroactive Repeal of the Multistate Tax Compact (* Vol. 14, Issue 5, Oct. 2014) available under publications at www.bakermckenzie.com.

The retroactive repeal of the MTC election effective as of January 1, 2008 (the "2008 MTC Repeal") is the state's second repeal of the MTC election. On May 25, 2011, the Michigan legislature repealed the MTC election provision effective as of January 1, 2011 (Public Act 40 of 2011). The effective date of this first retroactive repeal of the MTC election provision was of significance to the Michigan Supreme Court in *IBM*, as the court noted that "[t]here is no dispute that the Legislature specifically intended to retroactively repeal the Compact's election provision for taxpayers subject to the [MBT] beginning January 1, 2011. . . . the express repeal of the Compact's election provision effective January 1, 2011, is evidence that the Legislature had not impliedly repealed the provision when it enacted the [MBT].” Following the second retroactive repeal of the MTC election provision, the Department filed supplemental authority to its request for rehearing in *IBM* in order to address the 2008 MTC Repeal, and the Michigan Supreme Court denied the Department’s request for rehearing. But this is not the end of the MTC election controversy.

The MTC saga continues in similar Michigan cases that address the taxpayers’ ability to elect the MTC apportionment formula for tax years prior to 2011 in light of the 2008 MTC Repeal. These cases include: *Anheuser-Busch v. Department of Treasury, Lorillard Tobacco Co. v. Department of Treasury*, and *Arby’s Restaurant Group v. Department of Treasury*. It is questionable which, if any, of these cases will be the first to address the 2008 MTC Repeal, but they are all contenders for the title of lead case on this issue.

Lead Case Contenders on the 2008 MTC Repeal Issue

Anheuser-Busch is currently before the Michigan Court of Appeals, which ordered Anheuser-Busch, Inc. (“Anheuser-Busch”) to file a supplemental brief addressing the effect of the 2008 MTC Repeal. Despite this order, it is unclear whether the Court of Appeals will address the 2008 MTC Repeal in its ruling because it was not previously addressed at the Michigan Court of Claims and is now being raised for the first time on appeal. As a general matter, Michigan’s appellate courts do not rule on issues raised for the first time on appeal, absent exceptional circumstances; however, the 2008 MTC Repeal could very well be considered an exceptional circumstance warranting first-impression consideration by the state’s highest courts.

In *Lorillard*, the Michigan Court of Appeals ruled in favor of the taxpayer and denied the Department’s motion of reconsideration that was based on the 2008 MTC Repeal. *Lorillard* could potentially end up becoming the lead case on the 2008 MTC Repeal if the Department successfully appeals to the Michigan Supreme Court and that court addresses the 2008 MTC Repeal issue. But given the procedural posture of *Anheuser-Busch* and *Lorillard* and the appellate courts’ traditional resistance to opine on issues that were not initially raised at the trial court level, the *Arby’s* case before the Michigan Court of Claims could be the first court to opine on the effect of the 2008 MTC Repeal.

Substantive Challenges to the 2008 MTC Repeal

Regardless of which case first addresses the 2008 MTC Repeal, the resolution of the substantive issues related to the 2008 MTC Repeal will be of great interest, not only to the Michigan taxpayers who have filed refund claims but also to taxpayers in other states where similar challenges to the MTC election are ongoing. Some of the more persuasive substantive arguments raised by the taxpayers address the membership withdrawal terms of the Compact itself, the potential applicability of the Contract Clause of the US constitution, and reconciling the actions of the Michigan legislature in its first and second repeals of the MTC election provision.

Membership Withdrawal Provisions of the Compact and the Contract Clause

Reconciling a retroactive withdrawal from the Compact with the membership terms of the Compact is a difficult proposition, considering that the Compact contains language that appears to be designed to prevent retroactive withdrawal and further considering the constitutional Contract Clause issue of whether retroactive legislation may override the Compact. MTC Article X, "Entry Into Force and Withdrawal" provides that a state legislature may enact legislation to withdraw from the Compact; however, "[n]o withdrawal shall affect any liability already incurred by or chargeable to a party State prior to the time of such withdrawal." This latter provision could be viewed to be in direct conflict with the 2008 MTC Repeal depending on how the liabilities associated with tax years 2008 to 2010 are ultimately categorized.

A related consideration is the Contract Clause of the US constitution, which generally prohibits state laws that impair state obligations pursuant to its contracts. Assuming that the MTC Compact is recognized as an interstate contract to which Michigan is a party and that the taxpayers have standing to enforce its terms, the 2008 MTC Repeal could be subject to judicial review as to whether it passes constitutional muster pursuant to the Contract Clause.

Retroactively Imputing Legislative Intent

Another significant issue that could be addressed by the Michigan courts is the legislature's ability to override the *IBM* case--a case decided in part on the Michigan Supreme Court's interpretation of the legislature's intent. As discussed above, the court in *IBM* considered the effect of the legislature's decision to repeal the MTC election provision effective as of January 1, 2011 when determining IBM's ability to make the MTC election for tax year 2008.

In contrast, Public Act 282 of 2014 provides that the original legislative intent of the legislature which enacted the MBT was to repeal the MTC election in connection with its enactment of the MBT's single sales factor apportionment formula. Public Act 282 further provides that the 2011 Michigan legislature that repealed the MTC election provision effective as of January 1, 2011 ". . . was to further express the original intent of the legislature. . . ." This language potentially undermines the *IBM* court's ruling. Further, whether the 2014 Michigan legislature even has the ability to dictate the original intent of prior legislatures is questionable and raises separation of powers questions regarding the role of the judicial branch.

The retroactive repeal arguments outlined above, among others, have potential to take center stage in the Michigan MTC debate. Depending on the timing of the decision(s), the resolution of this issue by the Michigan courts could also influence courts in other states considering MTC issues. Until then, taxpayers both in Michigan and elsewhere should monitor the progress of the lead case contenders in Michigan to see how the issue develops.

By John Paek, Palo Alto and Drew Hemmings, Chicago

A Real Game Changer?: *Temple-Inland v. Cook* and the Future of Unclaimed Property in Delaware

On May 21, 2014, Temple-Inland, Inc. ("Temple-Inland") filed a complaint in the US District Court for the District of Delaware seeking injunctive and declaratory relief from Delaware's application of its unclaimed property laws. The complaint names as defendants three Delaware unclaimed property officials along with Kelmar Associates LLC ("Kelmar"), Delaware's primary third-party auditor, and states multiple causes of action which include a host of alleged Constitutional violations. At the heart of the case is the extrapolation methodology that Delaware has employed to estimate the unclaimed property liability of holders in years for which complete books and records are unavailable.

This is at least the second time a lawsuit has been filed against Delaware in federal district court challenging that methodology. Just last year, in *Select Medical Corp. v. Cook*, Select Medical Corporation sued Delaware alleging violations similar to those set forth in Temple-Inland's complaint. However, that case never reached trial and was ultimately settled after Select Medical Corporation was able to produce records that Delaware deemed adequate. As such, Temple-Inland's lawsuit could result in the first federal court decision on the validity of Delaware's extrapolation methodology used in its unclaimed property audits.

Temple-Inland is a Delaware-incorporated packaging company with operations in various states. In 2008, Temple-Inland was contacted by Delaware and notified that it would be subject to an audit administered by Kelmar for 1986 through 2009 ("Period at Issue"). Consistent with its internal record retention policy at the time, Temple-Inland only had complete books and records for its payroll and accounts payable disbursements dating back to 2003 and 2004, respectively. Accordingly, Kelmar only audited Temple-Inland's disbursement records for the 2004-2009 period ("Audit Period") and used an extrapolation formula to estimate a liability for the 1986 through 2003 period ("Estimation Period").

According to the complaint, the extrapolation formula that was used to estimate Temple-Inland's liability was comprised of an "escheat percentage" multiplied by Temple-Inland's revenue during the Estimation Period. This escheat percentage is described as a fraction, the numerator of which is the sum of property purported to be escheatable during the Audit Period, which included the value of unclaimed property that was escheated to other states, and the denominator of which is Temple-Inland's total revenue during the Audit Period. During the course of the audit, the application of this escheat percentage to the Estimation Period is alleged to have yielded an estimated unclaimed property liability in excess of $2 million, even though, according to the complaint, Kelmar only identified a single outstanding payroll check in the amount of $147.30 that should have been escheated to Delaware as unclaimed property during the Audit Period. Notably, while Delaware currently imposes a statutory requirement on domestic corporations to keep and maintain records for purposes of unclaimed property audits, such requirement was not enacted until 2010 — two years after Temple-Inland was initially contacted for audit.

The complaint alleges that the estimation methodology employed by Kelmar violates federal common law by ignoring the Supreme Court precedent established by *Texas v. New Jersey* and its progeny. In that case, the US

Supreme Court set forth a series of priority rules pursuant to which states determine their respective rights to intangible unclaimed property. These rules establish a first priority right to the state of the last known address of the property owner and a second priority right to the state of the holder’s domicile. Pursuant to these rules, Temple-Inland asserts that property must be specifically identified in order to be subject to escheat and that the estimation methodology is therefore inconsistent with *Texas v. New Jersey*.

Temple-Inland also alleges that Kelmar's estimation methodology unlawfully applies Delaware's 2010 document retention statute retroactively. The complaint alleges that such retroactive application violates the *ex post facto* clause and Temple-Inland 's due process rights. As stated in the complaint, a decision in Delaware's favor "would require that [Temple-Inland] pay a penalty for failure to maintain records in periods prior to 2010 when, at the time, there was no such obligation and [Temple-Inland] had no notice it was required to do so." In addition to the alleged common law and due process violations, the complaint also alleges that Delaware's estimation methodology violates the Full Faith and Credit Clause, Commerce Clause, and Takings Clause of the US Constitution.

The Underlying Problem

The facts surrounding Temple-Inland's complaint underscore the need for meaningful reform in the unclaimed property arena. Unclaimed property laws, which are enacted in all fifty states, were initially devised to provide a mechanism to reunite lost or abandoned property with its rightful owner. Under these laws, the state acts as a custodian of the abandoned property until the rightful owner claims it.

However, the unclaimed property law in Delaware appears to have evolved from its original purpose of custodial safekeeping to revenue generation. Indeed, according to estimates published by the Delaware Economic and Financial Advisory Council, unclaimed property is Delaware's third largest revenue source. Delaware's situation is unique, as it seems to have leveraged its position as the most popular state of incorporation to exploit domestic corporations on the unclaimed property front.

Delaware is typically the first choice among business organizations of states in which to incorporate because it is generally considered to have favorable corporate laws. However, as of late, the benefits of incorporating in Delaware may be overshadowed by Delaware’s unclaimed property audit positions, which are frequently perceived as aggressive. The escheat priority rules arguably allow Delaware to receive all intangible unclaimed property for which the owner’s last known address is unknown from Delaware-incorporated entities. As Temple-Inland's complaint illustrates, a holder will often have no contact with Delaware other than the fact that it is incorporated there, and aggressive enforcement tactics have led to unfair results.

Once an audited is initiated, Delaware holders have been confronted with practical hurdles when asked to produce books and records dating back almost three decades. Moreover, the retention of third party auditors on a contingent fee or commission basis only appears to have exacerbated the problem because such arrangements incentivize aggressive audit behavior by outside firms seeking to inflate their own bottom line.

The Road to Reform

In an apparent effort to repair its business-friendly image, the state has made substantive revisions to its unclaimed property law over the past year. Delaware Senate Bill 228, enacted on June 30, 2014, significantly reduced the penalties that apply to holders who fail to file an unclaimed property report. Previously, a holder who failed to file a report would be subject to a penalty equal to 5% per month of the amount of unclaimed property required to be shown on the report and capped at 50% of the amount due. Senate Bill 228 has reduced that penalty to 5% per month, or $100 per day, with a $5,000 cap. More importantly, the proposed legislation completely eliminates the interest on unreported unclaimed property—an often significant amount that holders were historically required to pay.

In addition, Delaware has introduced a bill that would curtail the state's use of third party auditors. Senate Bill 215, which is currently before the Senate Banking Committee, would forbid the Delaware State Escheator from paying outside auditors on a commission basis. In addition, the bill would prohibit audit contracts from extending beyond three years.

While these changes are a positive step towards a fairer system, the *Temple-Inland* case should be closely monitored because an ultimate resolution in Temple-Inland's favor could potentially have the most significant impact to Delaware's unclaimed property administrative practices.

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Baker & McKenzie Announces Three Important Seminar Opportunities in the Coming Months …

Tax Practitioners Gather in Record Numbers in San Diego

Start the New Year off in sunny San Diego if you're able, and be a part of Baker & McKenzie's 37th Annual North American Tax Conference, being held this year at the Hotel del Coronado. As part of this multi-day meeting, over 250 tax attorneys and economists will gather on Friday, January 9th, for a full-day Workshop entitled simply ***"Let's Talk Tax"*** and we are pleased to invite our newsletter readers and clients to participate.

The January 9th workshop will begin with a morning general session focusing on how US tax legislation and BEPS may impact businesses in 2015, followed by several breakout sessions throughout the day that will address other recent tax developments and trends in the areas of tax planning and dispute resolution. The goal of the program is to be as interactive as possible and to provide our corporate guests with opportunities to ask questions and to share their experiences while actively discussing the latest tax developments with the Firm's tax practitioners from around the US and Canada, and elsewhere around the globe.

Complete agenda and registration details for the January 9th Tax Workshop can be accessed via the link here ***North America Tax Conference***, or by emailing **TaxNews@bakermckenzie.com.** There is no fee to attend, but registration is required.

In addition to the Friday workshop, interested attendees also have the opportunity to arrange private meetings on Thursday, January 8th, with Baker & McKenzie tax practitioners from the US and Canada, as well as those from Europe, Asia and Latin America who will be in San Diego to support this event. These spots are at a premium, so please contact **Carol Alexander** in Chicago at 312-861-8323 or email **TaxNews@bakermckenzie.com** if you are interested in arranging such a meeting.

16th Annual Latin American Tax Conference Returns to Miami

From the Golden State to the Sunshine State, Baker & McKenzie also invites you to join our Latin American tax practitioners as they convene March 17-19, 2015 in Miami, Florida for their ***16th Annual Latin American Tax Conference***. This multi-day program will offer an in-depth look into the Latin American tax landscape with representatives from several Latin American countries, who will be joined by colleagues from the US and key European jurisdictions. Opportunities will also be provided for registered guests to meet one on one with practitioners from various Latin American jurisdictions. Complete conference details, agenda, and registration information are accessible at the event's **web page**.

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12th Annual Global Tax Planning and Transactions Workshop in New York City in April

Looking ahead to the Spring, on April 29th and 30th, Baker & McKenzie's North America Tax Practice Group will host its 12th Annual Global Tax Planning and Transactions Workshop, ***The BEPS Project - A Game Changer for Tax Planning and Transactions***, at the Crowne Plaza Hotel on Times Square in New York City. From legislative and administrative actions to aggressive audits, the BEPS project has become a game changer for multinationals as they plan their international tax structures and execute their transactions.

An extra half day has been added to the Workshop this year to accommodate a discussion of risks and pre-emptive measures across a broad range of topics - including inversions, supply chain planning, intellectual property planning, transfer pricing, anti-deferral measures, financing methods, bi-lateral and multi-lateral tax treaties, tax audits and controversies, and tax reporting - that the BEPS project and BEPS-inspired measures have already impacted or inevitably will impact. Attendees will also have the opportunity to schedule private meetings with Baker & McKenzie professionals from around the world who will be in town to support this signature event. A detailed agenda and invitation will be distributed in the coming weeks. To ensure you receive an invitation directly, kindly **register** your interest at http://bakerxchange.com.

* * * * *

We look forward to seeing you in the coming year, either at these programs in San Francisco, Miami and New York or elsewhere as we attempt to keep our clients informed of current tax developments and provide analysis of how best to address those new developments. Until then, on behalf of the editors of ***Tax News and Developments*** and each of Baker & McKenzie's North American Tax Practitioners, we would like to wish you and your families a Happy and Healthy Holiday Season and a Prosperous New Year!

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For further information regarding the North American Tax Practice Group or any of the items or Upcoming Events appearing in this Newsletter, please contact Carol Alexander at 312-861-8323 or carol.alexander@bakermckenzie.com.

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