Tax News and Developments

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Getting Better All the Time…Jerred Blanchard Joins Baker & McKenzie in Houston

Baker & McKenzie is pleased to announce the recent addition of **Jerred Blanchard** to our US tax practice. With decades of experience advising US and multinational clients on a wide variety of domestic and international tax planning issues, Jerred has gained a national reputation among his peers as one of the most knowledgeable attorneys in the US with regard to complex M&A transactions, Subchapter C, and US consolidated return issues.

Jerred will be an outstanding asset to our clients and is a welcome addition to the group, adding to the depth and breadth of our award-winning tax practice in the US and in Houston. His practice will concentrate on federal income tax planning for corporations and shareholders, Subchapter C and partnerships, consolidated return regulations, bankruptcy matters with regard to the preservation of tax attributes in connection with insolvency proceedings, and cross-border mergers and acquisitions.

An accomplished author, Jerred literally and figuratively "wrote the book" on consolidated return issues, as co-author of one of the leading treatises on the subject, *Federal Income Taxation of Corporations Filing Consolidated Returns*. Jerred has also written numerous articles in various professional journals over his 30 year career and is a frequent speaker on a variety of tax topics. He was a member of the 11th District Advisory Committee of the Board of Directors of the Federal Reserve Bank at Dallas and has been recognized as a leader in his field by the International *Who's Who in CorporateTax.*

Jerred joins Baker & McKenzie from the Houston office of a Big Four accounting firm, where he had been a partner in their National Tax Practice. He received his Masters of Law in Taxation from New York University School of Law, his Juris Doctor from Vanderbilt University Law School and his Bachelor of Arts from Yale University.

Please join us in welcoming Jerred to the North America Tax Practice!

Change is in the Air: Tax Policy in 2015

The November 2014 election brought change to Washington. The Senate flipped to Republican control, and key members of Congress retired (including Ways and Means Chairman Dave Camp and Permanent Subcommittee on Investigations Chairman Carl Levin).

This will be a busy year for tax policy as Congress continues to work through tax reform and several must-pass bills. This article will address the current state of tax reform and various issues that will be addressed in the current Congress.

Revenue Scoring

Probably the most challenging part of tax reform and any large tax package is the need to find revenue to offset the cost of new spending. The House Republicans

Upcoming Tax Events:

Breakfast Briefing: UK and China Tax Update
New York, New York
February 24, 2015

International Financial Services Business Briefing
New York, New York
February 26, 2015

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

Wealth Management Workshop: Trends and Reforms Affecting Wealth Management Structures for Latin American Individuals and Families
Miami, Florida
March 17, 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

TEI Audits & Appeals Seminar
Chicago and San Francisco
May 19-21, 2015

EMEA Tax Conference
Paris, France
June 3-6, 2015

Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference
Washington, DC
June 11-12, 2015

passed a budget instruction in the new Congress to require the Joint Committee on Taxation to dynamically score tax legislation. This would require the Joint Committee to consider the macro-economic effects of tax legislation, including tax cuts. It is argued that dynamic scoring may provide more flexibility and better scoring results for tax cuts, which could allow the tax-writing committees to bring down rates below the levels discussed in the last Congress. To date, the Senate has not considered a similar change.

Tax Reform is Back!

On January 15, 2015, Senate Committee on Finance Chairman Orrin Hatch (R-UT) and ranking minority member Senator Ron Wyden (D-OR) announced the formation of five working groups that are tasked with creating bipartisan tax-reform proposals. The five working groups and their co-chairs are listed below:

Group	Co-Chair Republican	Co-Chair Democrat
Individual Income Tax	Senator Grassley (IA) & Senator Enzi (WY)	Senator Stabenow (MI)
Business Income Tax	Senator Thune (SD)	Senator Cardin (MD)
International	Portman (OH)	Senator Schumer (NY)
Savings & Investment	Crapo (S-ID)	Brown (OH)
Community Development	Heller (NV)	Bennet (CO)

The working groups will be staffed by the professional staff at Senate Finance, along with the tax staff from each member's office. Chairman Hatch provided significant latitude to groups to decide how to interact with stakeholders. Each group will work through the middle of April 2015 to learn about the areas at issue, with a goal of providing deliverables to Chairman Hatch by May 25. The Joint Committee on Taxation will provide background materials and briefings, and, similar to its role for the working groups at the House Committee on Ways and Means in the last Congress, may act as the secretary. See Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups, JCS-3-13 (May 6, 2013).

It is unclear whether the working groups will provide a list of options, agreed- upon areas, or legislation that could be included in a tax-reform package. Moreover, Chairman Hatch has not provided instructions regarding the issues under consideration or the expected results. While Senate Finance will continue to hold hearings on tax reform, Chairman Hatch will likely hold fewer hearings than the prior two chairmen so that the Committee can do its work.

In the House, Ways and Means Chairman Paul Ryan has not outlined his process for tax reform. It is also unclear if Chairman Ryan will use former-Chairman Dave Camp's Tax Reform Act of 2014 as a basis or begin anew.

While the path to tax reform is uncertain, there are themes with business and international tax reform that are likely to carryover. First, both houses of Congress and the President agree that the corporate rate is too high and should be reduced. Second, the path for corporate rate reduction will likely include the repeal of preferences in the Internal Revenue Code, or tax expenditures. Repealing tax expenditures alone will not raise sufficient revenue, so there will likely be additional revenue raises to address loopholes or perceived abuses. Finally, tax reform will likely include anti-base-erosion rules, with an emphasis on currently taxing low-taxed foreign income. As the OECD and G-20 finalize their Base

Erosion and Profit Shifting deliverables (BEPS which are discussed hereinafter), it is unclear whether and how the debate in Paris will impact US tax reform.

While the odds are always against a large tax-reform bill, it is possible that the new Chairmen will consider piecemeal reform through more modest legislation. As a result, stakeholders should consider interacting with the working groups to provide timely input, as proposals developed by the working groups could be included in legislation.

The Highway Trust Fund Reauthorization

The Highway Trust Fund, the fund for highways and bridges, will expire on May 31, 2015. It is likely that there will be an effort to include a repatriation holiday to pay for roads. Both Chairmen Ryan and Hatch oppose a one-time tax holiday unless it is part of a broader reform that moves the United States to a territorial tax system. President Obama also generally opposes a temporary holiday. Nevertheless, Senator Barbara Boxer (D-CA) is working with Senator Rand Paul (R-KY) on a repatriation-holiday bill that will likely be introduced later in February. The bill would provide for an elective repatriation holiday at 6.5% less prorated tax credits. Only dividends that exceed a corporation's average over a period of time would qualify for the reduced rate. There are limitations on how the repatriated earnings and profits can be used. For example, the funds cannot be spent on increases in executive compensation, and cannot be used to increase dividends or stock buybacks for three years after the payment of the dividend. Second, the earnings must be used to increase hiring, wages and pensions, research, environmental improvements, public-private partnerships, capital, and acquisitions. The preferential dividend rate will be clawed back (with interest) if a company inverts within ten years of paying the dividend. According to the Joint Committee on Taxation, a prior version of the bill cost approximately $94 billion over ten years because corporations will accelerate future repatriations to take advantage of the tax holiday and will be incentivized to shift additional income outside the United States.

Senators Michael Bennet (D-CO) and Roy Blunt (R-MO) will introduce a bill later this month that will require a mandatory repatriation to pay for highways. The details of the bill, including the repatriation rate, are unknown at this time. However, unlike the Boxer-Paul proposal, the Bennet-Blunt proposal will not have any strings attached, and taxpayers will be able to use the funds as they see fit.

It is unclear whether a repatriation holiday will be passed as part of the reauthorization of the Highway Trust Fund, but there will be debate and possibly votes on one or both of these proposals.

Non-Controversial Markup in Senate Finance

Chairman Hatch is intent on restoring normal order in the Senate to tax legislation. Many recent deals between the House and Senate were negotiated by leadership and bypassed the normal order (markup in committee with amendments, followed by consideration on the floor). The consequences of such deals are many, including a lack of legislative history that taxpayers and the IRS can rely upon. Moreover, Finance Committee members lose the opportunity to build trust by working through difficult issues, which could affect making hard decisions in the context of tax reform.

On February 11, Chairman Hatch held a markup of 17 non-controversial tax bills. Chairman Hatch laid out six criteria for a bill to be considered: (1) the bill must be in the jurisdiction of the Finance Committee; (2) the bill must have bipartisan support and be *non-controversial* to Republicans and Democrats; (3) the proposal

must have little or no budgetary impact or must be accompanied with an acceptable offset; (4) the proposal must address a thoroughly reviewed subject matter; (5) the bill can not be actively opposed by Senate leadership or the White House; and (6) the bill must not be considered a limited tax benefit under Senate Rules. Modifications to extenders were ruled out of order, as were several pension proposals. Such bills included various proposals related to access to and administration of the US Tax Court. All 17 bills were successfully reported out of committee, and this process demonstrates Chairman Hatch's strong desire to restore normal order in the Senate.

Extenders

Consistent with former Chairman Camp's process in the last Congress, Ways and Means is in the process of marking up in committee some of the extenders with the purpose of making such provisions permanent. For example, Ways and Means marked up and passed out of committee a permanent patch to Code Section 179 (expensing for small businesses) without offsets. The House passed the bill, H.R. 636, on February 13, 2015. Other proposals that will be reported out of committee include the research credit and tax-free contributions from individual retirement plans for charitable purposes, but at this time there is no intent to markup and pass Code Section 954(c)(6) (CFC "look-through", which exempts from Subpart F certain payments between related controlled foreign corporations).

The House strategy reduces the cost of tax reform by making permanent extenders without having to find additional revenue to offset the cost. It is unclear if the Senate will similarly consider extenders on a one-by-one basis without offsets, and if presented with such bills, whether the President would exercise his veto power.

Other Bills

The US government will run out of borrowing capacity this year, likely in the summer. In prior years, tax offsets and tax changes were considered, and it is possible that tax issues may creep into the debate. Congress will also need to consider additional funding for Medicare for children and pass a budget or continuing resolutions to fund the government. Once again, these areas attract tax amendments, including offsets to new spending.

Investigations

There will likely be fewer investigations of multinational businesses by Congress, especially with the change in leadership in the Senate. However, it is likely that the House will continue its oversight of the Internal Revenue Service, and possibly the Senate will increase its focus as well. One question is how such investigations will affect the IRS budget and services that the IRS can provide to businesses and individuals.

The 114th Congress is off to a quick start on tax issues, and hopefully the parties can find common ground on extenders and tax reform well before the end of the year.

By Joshua D. Odintz, Washington, DC

Congress Extends Extenders in the Lame-Duck Session – Groundhog Day, Revisited

Following a 76-16 vote in the Senate, President Obama signed The Tax Increase Prevention Act, also known as extenders, into law on December 19, 2014. The extenders retroactively extended over 50 tax provisions that expired on December 31, 2013 through December 31, 2014. Some of the key extenders focus on crucial tax provisions from both a business and individual perspective.

The extenders of major concern to businesses are bonus depreciation for property placed into service by 12/31/2014, the research credit, Internal Revenue Code Section 954(c)(6) ("CFC Look Through"), the active financing exception from Subpart F income, and certain S corporation provisions. While a late extension of the business provisions causes issues with financial reporting especially for publicly traded corporations, Congress has repeatedly ignored this complaint.

Some of the extenders that affect individuals are the deduction for state and local sales tax for residents of states without income taxes, and enhanced current expensing for small businesses.

Earlier in 2014, the Senate tried to a pass a two-year extension (through 2015), but the bill failed to overcome a procedural hurdle because the Republicans were frustrated with the amendment process. The House Ways and Means Committee held several hearings and marked up various individual extenders, which the House passed but the Senate refused to take up.

Later in the year, then Ways and Means Committee Chairman Dave Camp and Senate Majority Leader Harry Reid tried to broker a deal that would have permanently extended some of the expiring provisions (e.g., research credit, bonus depreciation, and current expensing for small business), but the proposed deal fell apart due to a threat of a veto from the White House because the bill did not have sufficient middle-class tax relief. The deal would have cost more than $500 billion over ten years and would have provided certainty for the business community. Accordingly, the extenders package was put together during the lame-duck sessions, and the extended provisions expired a few weeks after their retroactive extension. While this provided certainty with regard to the 2014 tax year, there remains uncertainty as to tax planning for the extender provisions in 2015.

Thus far in 2015, the House Ways and Means Committee has taken steps towards permanently extending many of the provisions that expired on December 31, 2014, including the research credit, the deduction for state and local sales tax and current expensing for small businesses. Notwithstanding the above, there has been support from members of both parties to implement these permanent extenders along with overall tax reform. Once again, the House will push forward with individual bills, and it is unclear whether the Senate will consider these individual bills. Also, tax reform will need to consider whether to extend all of the more than 50 provisions, and transition relief for those provisions that will be allowed to permanently expire.

By Joshua D. Odintz, Washington, DC and Sean J. Tevel, Miami

The President's FY 2016 Budget – Change to the International Proposals

The President timely released his budget on February 2, 2015, and the Department of the Treasury released the Green Book, the collection of lengthier descriptions of the tax provisions. There are significant changes to the international tax proposals that, if enacted, could increase taxes on active foreign income of US- based multinationals.

Impose a 19-Percent Minimum Tax on Foreign Income

The Obama Administration proposed that the US currently tax active foreign income earned in "low"- tax jurisdictions by foreign subsidiaries. This active foreign income would be taxed at 19 percent with some modifications as described below. This proposal is either a partial repeal of deferral or a partial territorial tax system. The proposal would apply to a US shareholder of a Controlled Foreign Corporation ("CFC"), a US corporation with foreign branch operations, or a US corporation earning services income abroad. Subpart F income would continue to be taxed currently at the US corporate tax rate. Because the minimum tax would be imposed on an ongoing basis for foreign earnings, any earnings subsequently repatriated to the US would not be subject to any additional tax. The proposal would either tax foreign earnings immediately under the newly proposed minimum tax, or subpart F, or not at all so long as the earnings were subject to sufficient foreign tax or exempt from an allowance for corporate equity.

The proposal calculates the tax base for the minimum tax by creating an allowance for corporate equity ("ACE"), which is an exception from the tax for the "return based on the actual activities undertaken in a foreign country." ACE would exempt the risk-free return on equity invested in assets where the assets do not produce the aforementioned "passive" income. For example, if a UK CFC had $100 in income, had $500 of active UK assets, and assuming a risk free rate at 2 percent, then $10 in income would be exempt under ACE. This would leave the income subject to the 19 percent minimum tax at $90 rather than $100. Essentially, it is intended to carve out an exception for actual investment in assets and equity for the ongoing business in the foreign jurisdiction rather than the accumulation of passive income offshore.

Additionally, no US tax should be due on the subsequent sale by a US shareholder of stock in a CFC, as was previously the case under Code Section 1248. The gain previously attributable to the undistributed earnings of the CFC would now be taxed currently, and no untaxed earnings would remain for section 1248.

Impose a 14-Percent One-Time Tax on Previously Untaxed Foreign Income

The Administration also proposed a one- time, mandatory, 14 percent tax on untaxed foreign earnings earned before January 1, 2016, as part of tax reform. The proposal does not look at how the earnings and profits are invested (e.g., cash versus plant property and equipment) or provide for different rates depending on such investments.

It is worth noting that these two proposals look very similar to former Senate Finance Committee Chairman Max Baucus's "Option Z" proposal from his 2013

international tax reform plan. Chairman Baucus proposed to tax 60% of a CFC's active income at full US rates for an effective tax rate of 21 percent.

Chairman Baucus also proposed taxing currently all previously untaxed income much like the proposal in the Green Book. The details differ only in the rate and the time period over which the tax would be due. Chairman Baucus suggested a 20-percent rate payable over 8 years whereas the Administration proposed a 14-percent rate payable over 5 years.

Extend the Look-Through Treatment of Payments Between Related Controlled Foreign Corporations

The Green Book also suggests that the temporary subpart F "look-through" exception should be made permanent. The "look-through" exception has been extended since enactment, but is frequently extended retroactively. Last year, the Administration was silent on the extension of Code Section 954(c)(6).

Making the "look-through" exception permanent is necessary to be consistent with the other recommended changes to the subpart F regime and allows for the application of the minimum 19-percent tax on the CFC's income rather than requiring current taxation at full US statutory rates under subpart F.

Limit the Ability of Domestic Entities to Expatriate

Inversion transactions, where a US corporation is replaced by a foreign corporation under Code Section 7874, have garnered significant attention from the press, the government, and the Obama Administration. The Obama Administration's proposal is aimed at making it more difficult to engage in an inversion transaction and, once undertaken, to make it more difficult for inverted corporations to operate in the US as if they had never inverted.

Current law requires that "if the continuing ownership of historical shareholders of the domestic corporation in the foreign acquiring corporation is 80 percent or more (by vote or value), the new foreign parent corporation is treated as a domestic corporation for all US tax purposes (the '80-percent test')".Failing the 80-percent test essentially means the transaction has failed to effect an inversion. "If the continuing shareholder ownership is at least 60 percent but less than 80 percent, the foreign status of the acquiring corporation is respected but certain other adverse tax consequences apply, including the inability to use tax attributes to reduce certain corporate-level income." The proposal would make it more difficult to invert by replacing the 80-percent test with a greater-than-50- percent test and eliminate the 60-percent test altogether.

Second, even if the ownership thresholds are satisfied, the transaction would be treated as an inversion if, immediately before the transaction, the fair market value of the domestic entity is greater than that of the foreign acquiring corporation, the expanded affiliated group is primarily managed and controlled in the United States, and the expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

The proposal would also grant the IRS the ability to share tax-return information with other Federal agencies "for the purpose of administering an agency's anti-inversion rule." This provision is aimed at ensuring that other Federal agencies do not enter into contracts with inverted companies where Congress has passed legislation to prevent such contracts.

Restrict Deductions for Excessive Interest of Members of Financial Reporting Groups

The Administration also proposes to limit deductions for interest expenses among certain consolidated groups in order to further prevent base erosion and profit shifting. The proposal is very similar to one of the options under consideration at the Organization for Economic Cooperation and Development as part of Base Erosion and Profit Shifting Action 4. Under the proposal, “a member’s deduction for interest expense generally would be limited if the member has net interest expense for tax purposes and the member’s net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member’s proportionate share of the net interest expense reported on the financial reporting group’s consolidated financial statements (excess financial statement net interest expense)."

The Administration’s view is that base erosion occurs where a multinational group’s inter-company debt exceeds its third-party debt. The proposed response shows this by targeting all net interest rather than only the interest where an income base is eroded from high-tax jurisdictions to low-tax jurisdictions.

It is of note that the matching principle for interest income and expense is no longer in the proposal. The matching principle operates to ensure that no interest deduction is taken on an expense without a corresponding inclusion of income for the same interest elsewhere.

Miscellaneous Item Not in Proposal – Excess Return Proposal

Lastly, it may be worth noting a few items that were previously included in proposals that are not in the Green Book. The Excess Return proposal previously found in Obama Administration proposals to tax “excess returns” is not in the FY2016 Green Book. The prior proposals discussed taxing as subpart F income the transfer of intangibles from a US parent to CFCs in low-tax jurisdictions.

The 19-percent minimum tax demonstrates that the Administration is very interested in the US, and not other countries, taxing the low-taxed or no-where taxed income. As tax reform begins to take shape in the Senate and possibly the House, it will be interesting to see if either party looks at the Green Book proposals and considers the architecture of the proposals as part of broader tax reform. Certainly, some of these proposals will appear in amendments and will be introduced as legislation, but the chances of passage are very small outside of tax reform.

By Joshua D. Odintz, Washington, DC and Jason A. Graham, Dallas

The President's FY 2016 Budget - Individual Tax Reform

Proposals For High-Income Taxpayers

In addition to the international tax proposals discussed in the previous article, the FY 2016 Budget has continued certain proposals made in prior budgets, but includes new proposals affecting high-income taxpayers in order to ensure the Administration's view that the wealthiest pay their fair share of taxes.

Increase Capital Gains Tax Rate

The FY 2016 Budget has added a new proposal this year regarding the reforming of capital-gains taxation, which will particularly affect high-income taxpayers. Under current law, long-term capital gains and qualified dividends are taxable at graduated rates, with 20% generally being the highest rate for high-income taxpayers. In most high-income taxpayer cases, the capital gains and qualified dividends also would be subject to an additional 3.8% net-investment income tax causing the aggregate tax rate for long-term capital gains and qualified dividends to reach as high as 23.8%. The proposal would increase the top tax rate on long-term capital gains and qualified dividend tax rate from 20% to 24.2%, which could result in the top tax rate increasing to 28% when including the additional 3.8% net-investment income tax. The proposal would be effective for capital gains and qualified dividends received in taxable years beginning after December 31, 2015.

Elimination of Basis Step-Up on Death

The FY 2016 Budget proposes a significant change to the basis rules for transfers of appreciated property by gift or upon death. Under current law, persons who inherit appreciated property upon death are generally entitled to receive a basis in that asset equal to the asset's fair market value at the time of the decedent's death. As a result of the "stepped-up" basis in the asset, the appreciation accrued during the decedent's lifetime would never be subject to US income tax. With exceptions for surviving spouses, charities, and the middle-class, the proposal would be to treat transfers of appreciated property, both during lifetime by gift and upon death, as taxable sales of the property resulting in such appreciation becoming immediately subject to US income tax in the donor's hands in the year that the transfer was made. The proposal would also have significant tax consequences for those taxpayers resident in US states with a state income tax system, thereby increasing their state income tax exposures. Furthermore, such proposals would be in addition to any applicable US gift or estate tax exposures for the transfer of such appreciated property during lifetime or at the time of death. The proposal would be effective for gains on gifts made, and of decedents dying, after December 31, 2015.

Reduce the Value of Certain Tax Expenditures

The FY 2016 Budget contains a proposal that would limit the tax value of specified deductions or exclusions from adjusted gross income ("AGI") and all itemized deductions. Currently, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income (e.g., interest on State or local bonds), claiming certain deductions in the computation of AGI (e.g., amounts paid for employer-sponsored health coverage, defined contribution retirement plans), and claiming either a standard deduction or itemized deductions (subject to certain thresholds). Under current law, the tax reduction from the last dollar excluded or deducted is $1.00 times the taxpayer’s marginal income tax rate. For instance, if a taxpayer's marginal tax rate is 39.6 percent, then the tax value of the

last dollar deducted would equal 39.6 cents. The proposed limitation would cap the tax value to 28 percent of the specified exclusions and deductions, thereby reducing taxable income in the 33-percent, 35-percent, or 39.6-percent tax brackets. The proposal would apply to itemized deductions after they have been reduced by the statutory "Pease" limitation. If a deduction or exclusion for contributions to retirement plans or IRAs is limited by this proposal, then the taxpayer's basis will be adjusted to reflect the additional tax imposed. If enacted, the proposal would be effective for taxable years beginning after December 31, 2015.

Implement the Buffet Rule by Imposing a New "Fair Share Tax"

In addition to limiting the tax value of specified deductions, the FY 2016 Budget again proposes a new minimum tax, called the Fair Share Tax ("FST"), on high income taxpayers. The tentative FST would equal 30 percent of AGI less a specified credit for charitable contributions equal to 28 percent of allowable itemized charitable contributions. The final FST would be the excess of the tentative FST over the sum of the taxpayer's (1) regular income tax (after specified credits) including the 3.8-percent net-investment income tax, (2) the alternative minimum tax, and (3) the employee portion of payroll taxes. Finally, the amount of FST payable (i.e., the excess of tentative FST over the regular tax) would be phased in linearly starting at $1 million of AGI for a single taxpayer and fully phased in at $2 million of AGI ($500,000 and $1 million for married filing separately, respectively).

Modify US Estate, Gift and Generation-Skipping Transfer ("GST") Tax Provisions

Restore 2009 US Gift, Estate, and GST Tax Provisions

As proposed in prior budgets, the FY 2016 Budget would make permanent the US estate, gift, and GST tax parameters as they applied during 2009. The top tax rate would be increased from 40% to 45%. The exclusion amount (unified credit) would be decreased from $5 million (adjusted for inflation and currently $5.43 million) to $3.5 million for US estate and GST taxes, and would return to $1 million for US gift taxes, but no US estate tax or gift tax would be incurred by reason of such decrease of the exclusion amount with respect to prior gifts that were excluded under the parameters of current law. There would be no indexing for inflation. Although not discussed, it would seem that the exclusion for non-residents will remain at only $60,000. The proposal would continue to allow portability of unused estate and gift tax exclusions between US citizen spouses. Unlike the prior budget, the proposal would be effective for estates of decedents dying, and for transfers made, after December 31, 2015.

Modify Transfer Tax Rules for Grantor Retained Annuity Trusts ("GRATs") and other Grantor Trusts

The FY 2016 Budget combines last year's GRATs and grantor trust proposals into a single proposal, with some modifications. Under current law, donors use certain types of trusts to hold assets in a way that allows the donor to receive a stream of income from those assets, while transferring expected appreciation to donees, without paying US gift tax, and with minimal US income tax costs. If all goes according to plan, the appreciation in the assets will escape US estate taxation with little downside risk to the taxpayer. The proposal would make overly generous outcomes more difficult to achieve by requiring that donors leave assets in GRATs for a minimum of 10 years plus the grantor's life expectancy, with a new proposal that the remainder interest in the GRAT (i.e., the taxable gift portion)

must have a minimum value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000. This would effectively eliminate the planning to achieve "zeroed-out" GRATs that result in virtually no US gift tax. With the proposal to return to a US gift tax exclusion of only $1 million, such planning would potentially make the use of GRATs more unattractive to taxpayers. In addition, the proposal would prohibit any decrease in the annuity during the GRAT term, and, new this year, would prohibit the grantor from engaging in a tax-free exchange of any asset held in the GRAT under commonly known "swap" provisions.

The proposal would also deter the popular use of sales of appreciated assets to grantor trusts by requiring that the portion of the trust attributable to the property received by the trust in the sale transaction (including all retained income and appreciation) be subject to US gift tax when the grantor is no longer the deemed owner of the trust under US income tax rules or upon a distribution to another person during the life of the deemed owner, or by requiring that such assets be included in the gross estate of the deemed owner and subject to US estate tax at the time of death.

The proposal would be applicable to GRATs created after the date of enactment. The proposal as to transactions with other grantor trusts would be effective with regard to trusts that engage in a transaction on or after the date of enactment.

Other Proposals

As in prior budgets, the following proposals are continued in the FY 2016 Budget:

(i) Require consistency in valuation and basis and reporting of valuation and basis by donors and estates to donees, beneficiaries, and the Service;

(ii) Terminate the US GST tax exemption allocated to long-term or perpetual trusts on the 90th anniversary of the creation of the trust so as to cause such trusts to be subject to GST tax thereafter;

(iii) Eliminate the use of certain trusts that make medical expense or tuition payments directly to qualified providers or educational institutions for a grandchild free of US gift or GST tax, by requiring that such payments must be made by a living donor directly to the medical facility or education institution in order for the US GST tax exclusion to apply;

(iv) Extend the US estate-tax lien applicable to estates throughout the entire period that the US estate tax is deferred under Code Section 6166;

(v) Limit a donor’s total annual exclusion gifts to $50,000 per donor for those types of transfers where the donee would not be able to easily liquidate the gifted property;

(vi) Expressly make the US tax code’s definition of "executor" applicable for all tax purposes, and authorize such executor to do anything on behalf of the decedent in connection with the decedent’s pre-death tax liabilities or obligations that the decedent could have done if still living.

Simplify the Tax System

Provide Relief for Certain "Accidental" US Citizens

The FY 2016 Budget unveils a new proposal that would provide relief to individuals who may not learn until later in life that they are US citizens having dual-citizenship since birth and may be citizens of countries where dual citizenship is illegal and have had minimal contact with the United States. As US citizens, these individuals would be subject to US income tax on their worldwide income, regardless of whether they live outside of the United States. The Administration recognizes that some of these individuals upon finding out about their accidental US citizen status would like to relinquish their US citizenship, but doing so may result in paying significant US income tax under Code Section 877A in order to certify under penalties of perjury that he or she has been US tax and reporting compliant for the 5 years preceding the year of expatriation. By being unable to certify US tax compliance, such individuals would meet the definition of a "covered expatriate" under the provisions of section 877A and may be required to pay a mark-to-market "exit tax" on a deemed disposition of their worldwide assets as of the day before their expatriation date. Under the proposal, an individual will not be subject to tax as a US citizen and will not be a covered expatriate subject to the mark-to-market exit tax under section 877A if the individual:

(1) became at birth a citizen of the United States and a citizen of another country,

(2) at all times, up to and including the individual's expatriation date, has been a citizen of a country other than the United States,

(3) has not been a resident of the United States (as defined in Code Section 7701(b)) since attaining age 18½,

(4) has never held a US passport or has held a US passport for the sole purpose of departing from the United States in compliance with 22 CFR §53.1,

(5) relinquishes his or her US citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he or she is a US citizen, and

(6)) certifies under penalty of perjury his or her compliance with all US federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period (i.e., paid all applicable US income tax on income earned from US sources)

The proposal would be effective January 1, 2016.

Tax Carried (Profits) Interests as Ordinary Income

Given the notoriety that the reduced taxability of an individual service partner's "carried interest" in a partnership has drawn in recent years, the FY 2016 Budget contains a proposal that would tax as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. In order to further prevent income derived from labor services from avoiding taxation at ordinary income rates, the proposal would assume that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain.

Tax Gain from the Sale of a Partnership Interest on Look-Through Basis

Also in the area of partnerships, the FY 2016 Budget contains a proposal that would provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade of business in the United States to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States. In addition, the proposal would require the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certified that the transferee is not a nonresident alien or foreign corporation, or provides a certificate from the IRS that established that the transferor's US federal income tax liability with respect to the transfer was less than 10 percent of the amount realized.

By Jennifer J. Wioncek, Miami and Daniel W. Hudson, Miami

OECD Releases Discussion Drafts on BEPS Action Items 4 and 14

On December 18, 2014, the OECD released a discussion draft for BEPS Action 14, titled "BEPS Action 14: Make Dispute Resolution Mechanisms More Effective." The objective of Action 14 is to develop solutions to address obstacles that prevent countries from solving treaty-related disputes under the mutual agreement procedure ("MAP"). On the same day, the OECD released the first discussion draft for BEPS Action 4 titled "BEPS Action 4: Interest Deductions and Other Financial Payments." The objective of Action 4 is to prevent base erosion and profit shifting by using deductions for interest and other financial payments. This article provides a summary of the Action 14 and Action 4 discussion drafts.

These discussion drafts are among the latest deliverables produced pursuant to the OECD's 15-point Action Plan on Base Erosion and Profit Shifting ("BEPS"). Earlier deliverables have been discussed in prior editions 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) and *OECD Delivers Two New Discussion Drafts As Part of its Action Plan on Base Erosion and Profit Shifting* (Vol. 14, Issue 6, December 2014) located under publications at www.bakermckenzie.com.

BEPS Action 14: Make Dispute Resolution Mechanisms More Effective

The discussion draft for BEPS Action 14 illustrates the OECD's commitment to improving the effectiveness of dispute resolution proceedings under the MAP of bilateral tax treaties. In doing so, the discussion draft identifies a number of current obstacles that hinder dispute resolution through the MAP and calls on contracting states to address those obstacles through the framework of four general principles, as summarized below.

The first principle adopted to improve the MAP process is ensuring good faith implementation of treaty obligations relating to MAP. Most notably, the authors suggest that the absence of an obligation to resolve MAP cases under the current interpretation of Article 25 of the OECD Model Treaty is itself an obstacle to the resolution of disputes. In addition, the absence of Paragraph 2 of Article 9 (providing for secondary corresponding adjustments following an Article 9

adjustment in another jurisdiction) in some treaties frustrates the primary objective of tax treaties - the elimination of double taxation. The discussion draft recommends addressing these impediments through revisions and commentaries to the relevant treaties.

The second principle focuses on administrative processes that promote the prevention and resolution of treaty-related disputes. The discussion draft proposes measures to increase efficiency and objectivity in MAP proceedings. For example, timely and efficient case resolution is achievable if countries allocate adequate resources (personnel, funding, training, etc.) to their competent authority ("CA") offices. Further, disputes can be prevented if more countries participate in bilateral APA programs and apply the agreed results to transactions across multiple years, including roll-back to audit years. On the other hand, countries can encourage an objective environment for MAP proceedings by safeguarding the autonomy of the CA office from the local audit functions and urging CA staff to focus on factors such as consistency, timely resolution of cases, and principled and objective MAP outcomes, rather than maintaining tax revenues already collected. Lastly, the discussion draft discourages certain practices by field auditors that pressure taxpayers to forego their right to initiate a MAP in exchange for perhaps a lighter settlement offer.

The third principle emphasizes the importance of taxpayers' ease of access to the MAP when eligible. The discussion draft calls for greater transparency and simplicity in the procedures required for taxpayers to access and use MAP, reducing excessive or unduly onerous documentation requirements for MAP requests, providing guidance on the relationship between the MAP and domestic law remedies, clarifying issues connected with time limits to access the MAP, and addressing ambiguities related to MAP and self-initiated foreign adjustments.

Finally, the last principle is ensuring that cases are resolved once they are in the MAP. The authors encourage tax administrators to commit to conducting fair and objective MAP negotiations based on good-faith application of the treaty and to foster cooperative and transparent working relationships with their counterparts. This will allow CAs to keep an open dialogue and continue to hold frequent meetings to resolve cases. In addition, while acknowledging the existence of controversies surrounding mandatory arbitration, the discussion draft suggests revisiting this topic and addressing some of the policy concerns that discourage countries from utilizing this mechanism.

This discussion draft was the OECD's first step in recognizing several common factors across treaty countries that hamper CA dispute resolution processes. While the obstacles identified and the suggested measures resonate with taxpayers and practitioners, the authors fail to highlight the relative significance of a number of the issues in comparison to others. For example, two fundamental difficulties in the MAP process are the lack of resources of tax agencies and the aggressive and unprincipled positions taken by certain countries that jeopardize effective CA working relationships. Although the OECD has proposed reasonable measures to address such difficulties, the solutions will only be effective when most, if not all, countries commit to implementing the changes in a uniform manner.

BEPS Action 4: Interest Deductions and Other Financial Payments

The Action 4 discussion draft outlines approaches for limiting interest deductions and identifies challenges to developing recommendations under Action 4. Action 4

arises from a concern that multinational groups are able to erode the tax base and shift profits via excessive interest deductions. In many jurisdictions, debt financing generates tax-deductible interest expense for the borrower and taxable interest income for the lender. Taxpayers might structure intragroup debt to generate deductible interest payments in a high-tax jurisdiction and taxable interest income in a low-tax jurisdiction. According to the discussion draft, the use of hybrid financial instruments, hybrid entities, and preferential tax regimes increases base erosion and profit shifting concerns.

The discussion draft addresses three main types of rules to limit interest deductions. The three main types of rules are:

1. Fixed-ratio rules that limit deductions by reference to a fixed ratio (e.g., debt to equity, or interest to "EBITDA" (earnings before tax, depreciation and interest));

2. Group-wide rules that limit deductions by reference to the group of which the entity is a part; and

3. Targeted anti-avoidance rules that limit deductions in specific transactions (e.g., related-party transactions, conduit arrangements, and excessive-debt pushdowns).

As a general matter, the OECD prefers a group-wide rule but acknowledges that a combined approach using more than one type of rule could be most effective to curtail base erosion and profit shifting while minimizing burdens.

The OECD views group-wide rules as having the greatest potential to curtail base erosion and profit shifting. The theoretical underpinnings of this view are that: (i) the best measure for interest deductions within a group is the group's net third-party interest expense; and (ii) at the entity level, interest expense should match economic activity. Based on these premises, the discussion draft focuses on developing a rule that aligns interest deductions at the entity level with both the overall group's net third-party interest expense and the entity's level of activity.

Group-wide rules have advantages compared to other alternatives. For example, application of group-wide rules depends on group-specific analyses. Therefore, group-wide rules are better suited to entities in different sectors characterized by different leverage profiles. By contrast, fixed-ratio rules are generally inflexible in this regard because they apply the same ratio across all sectors.

Group-wide rules also have disadvantages. For example, having a group-wide rule apply to a multinational group requires a high degree of international consistency across jurisdictions to avoid distortions. There are also challenges in measuring economic activity to determine the appropriate share of group interest deductions for each entity within the group. Moreover, measuring economic activity of an entity based on its earnings or asset values means that volatility from year to year for a group member can limit that group member's ability to deduct its interest expense. The discussion draft contemplates the use of carry- forward mechanisms to mitigate these distortions; however, carry-forward rules will necessarily increase complexity.

The discussion draft suggested that countries might combine the rules discussed under Action 4. Such a combined approach might involve a general group-wide rule with a carve-out for entities that have a low fixed ratio (the low fixed ratio indicating a lower risk of base erosion and profit shifting). The combined approach could also use targeted anti-avoidance rules for specific transactions.

The concept behind the combined approach is that it will use the group-wide rule as a default but allow lower-risk entities (and perhaps tax administrations) to control compliance costs by using a fixed-ratio rule that is easier to apply. The availability and quality of group-wide data will be a key driver of compliance costs for groups under any group-wide rule. Therefore, it is unclear whether the low fixed-ratio carve-out will have a material impact on compliance costs if the group must incur additional costs under a group-wide rule.

The OECD's combined approach to Action 4 is similar to President Obama's Greenbook proposal in that it utilizes a group-wide rule with a carve-out for low fixed-ratio situations. The General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (the "Greenbook") outlines the White House's proposal for restricting interest deductions for members of financial reporting groups. Under the Greenbook proposal, a group member's US interest expense deductions would be limited to the member's interest income plus the member's proportionate share of the group's net interest expense. The member's proportionate share of the group's net interest expense would then be determined based on the member's proportionate share of group earnings. The Greenbook proposal's carve-out allows a member to elect to limit interest deductions to 10 percent of the member's adjusted taxable income.

The OECD's work on Action 4 cuts across several other BEPS Action items. In particular, Action 4 is intertwined closely with the OECD's work on hybrid mismatch arrangements, CFC rules, and pricing of related-party financial transactions, among others. Therefore, it is important to follow progress on these other action items in order to track progress on Action 4.

By Steven Hadjilogiou, Miami, Paul F. DePasquale, New York and Sahar Zomorodi, New York

Additional OECD BEPS Discussion Drafts on Transfer Pricing Action Items

On December 19, 2014, the OECD released a public discussion draft entitled "BEPS Actions 8, 9 & 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)." On December 16, the OECD also issued two additional discussion drafts related to Action 10, one related to cross-border commodity transactions and the other related to the use of profit splits in the context of global value chains.

Actions 8, 9, and 10 are the actions that are designated to "assure that transfer pricing outcomes are in line with value creation" under the OECD's Action Plan on Base Erosion and Profit Shifting ("BEPS"). Specifically, the stated goal of Actions 8 and 9 is to develop rules to prevent BEPS by either moving intangibles among group members (Action 8), or transferring risks among, or allocating excessive capital to, group members (Action 9). The goal of Action 10 is to develop rules to prevent BEPS by engaging in transactions that would not, or would only very rarely, occur between third parties. Each of the three discussion drafts is discussed below.

BEPS Actions 8, 9 & 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines

Part I of the discussion draft sets out lengthy proposed revisions ("Proposed Revisions") for Chapter I, Section D of the OECD Transfer Pricing Guidelines (i.e., "Guidance for applying the arm's length principle") (the "Guidance"). Much of the original guidance is incorporated into the Proposed Revisions. However, the

Proposed Revisions significantly adjust and expand very fundamental areas, including the treatment of contracts, comparability analysis, functional analysis, the approach to the analysis of risks, and the non-recognition of transactions.

1. Expanded Functional/Comparability Analysis**:** The Proposed Revisions focus on the differences between independent enterprises and related parties in their incentives to enter, enforce, and modify contracts. As a result, the Proposed Revisions require examining the conduct of the parties as well as the terms of the relevant contract, and call for further analysis if the conduct of the related parties is not consistent with the contractual terms. In cases in which the contract terms do not reflect the factual substance, then the conduct, functions, assets, and risks assumed and managed "should ultimately determine the delineation of the actual transaction." The Proposed Revisions also place comparability analysis "at the heart of the application of the arm's length principle" rather than as a general starting point. Two aspects of comparability analysis are identified in the discussion draft. First, the identification of the commercial or financial relations between the related parties within the comparability analysis allows for the description of the controlled transaction. Second, the comparability analysis examines the conditions of the controlled transaction against the conditions of potential comparable transactions between independent enterprises.

2. Expanded Analysis of Risks**:** The Proposed Revisions include a greatly expanded discussion of risks. They note differences in the manner risks are managed at arm's length versus between related parties, and expand the prior guidelines' discussion on how risk is managed, where the costs are borne, and how risk management should be rewarded.. The Proposed Revisions posit that mere ownership of assets and the financial capacity to bear risks may not be sufficient to entitle the owner to a risk-based return, where that owner does not have the ability to control, mitigate, or manage the risk. The theory behind this approach is that an unrelated party generally would not contractually assume risks that were controlled by the other party to the contract, and that such an allocation of risks in a related-party context is therefore suspect.

   Key to this discussion is the concept of "moral hazard," which refers to the lack of incentive to guard against risk where one is protected from its consequences. For example, moral hazard may exist at arm's length due to the unaligned incentives and asymmetric information of the parties, while related parties may have aligned incentives and symmetric information due to their common control. Another key concept is the risk-return trade-off (i.e., that a higher but less certain stream of income and a lower but more certain stream of income can have the same present value). The Proposed Revisions state that in related-party risk transfers, the risk-return trade-off should not be used on its own to justify the appropriateness of a risk transfer (on the theory that the same net risk remains in the controlled group after the transfer). Moral hazard, the risk-return trade-off, and the risks associated with financial transactions are highlighted as areas for further discussion.

3. Non-Recognition**:** The Proposed Revisions also include a substantially new discussion regarding circumstances under which accurately defined related-party transactions could potentially be disregarded or recharacterized by tax administrations, on the ground that they lack "the fundamental economic attributes of arrangements between unrelated parties." The Proposed Revisions state that the mere fact that a particular transaction does not occur between unrelated parties does not necessarily mean that it should be recharacterized. However, the draft suggests that the non-recognition option is necessary because controlled

groups have the ability to structure transactions that lack arm's-length characteristics, and that cannot therefore be priced under an arm's-length standard.

The Proposed Revisions would add to the Guidance a number of controversial concepts (e.g., moral hazards, risk-return trade-off, non-recognition) that could, if adopted, dramatically change the way taxing authorities analyze intercompany transactions. In fact, the Proposed Revisions appear to encourage taxing authorities to second guess taxpayer contractual arrangements, leading to re-characterization and controversy. Practitioners have expressed concerns that the Proposed Revisions incorrectly assume the assumption of risk is inseparable from decision making and that ownership of assets has limited impact upon risk allocation. Many practitioners are also concerned that many of the assumptions made in the Proposed Revisions are moving away from the arm's-length standard. In addition, another issue practitioners have cited regarding the draft is the level of detail at which transactions are expected to be analyzed. Throughout the draft, there is an emphasis on precision, which may be impractical to achieve in routine cases.

Part II of the discussion draft sets out five proposals for potential "special measures" in connection with intangible assets, risk, and over-capitalization. The draft states that the accurate description of the actual transaction, proper treatment of risk, and non-recognition of transactions that lack the fundamental attributes of arrangements between related parties will go a long way in aligning profits and value creation. However, according to the OECD, residual BEPS risks remain, which could potentially be addressed by special measures. Those risks relate mainly to information asymmetries and the ease of allocating capital to low-taxed, minimal functional entities. The five proposals on special measures are briefly described below:

1. Hard-to-value intangibles: Similar to the commensurate-with-income rules found in the Treasury Regulations to Code § 482, this proposal suggests that, if projected returns on a transferred intangible deviate significantly from actual results, taxing authorities could retrospectively adjust the price based on an imputed contingent payment mechanism.

2. Independent Investor: The target of this proposal is a capital-rich, asset-owning company (Company C) that depends on another company (Company R) to generate a return from the asset. In sub-option one, the independent investor (a party making an investment in a non-related entity) would consider Company R as offering a better investment option and invest directly in that company, which would be deemed to own the asset; therefore no return would be allowed to Company C. In the second sub-option, any income attributable to Company C would be reallocated to the parent company.

3. Thick Capitalization: This option depends on determining and applying a thick-capitalization rule based on a pre-determined capital ratio. Under this option, excess capital would be treated as a loan, and interest would be deemed paid to the parent. The draft does not address if these interest payments would be interest payments for all purposes.

4. Minimal Functional Entity: This option involves triggers that relate to the qualitative and quantitative attributes of the entity. It proposes a threshold of functionality under which, if certain triggers are met, the income would be reallocated either based on a pre-determined factor, to the parent, or to the company providing functional capacity. Functional capacity relates to the ability to create value through exploitation of assets and performance of risk management.

5. Ensuring Appropriate Taxation of Excess Returns: The primary proposal would apply a CFC rule taxing earnings to the parent if the income in the CFC is subject to a tax rate below a certain threshold. Additionally, a secondary rule would apply if none of the parent jurisdictions of a CFC has applied the primary rule. This would allocate taxing jurisdiction over the CFC's excess returns, where the effective tax rate is below a certain percentage, to other jurisdictions based on a pre-determined rule.

Practitioners have criticized the special-measure proposals as going beyond the scope of transfer pricing, and suggested that the concerns they are intended to address could be better covered by other BEPS Action items. US government officials have also expressed concerns with the special-measure proposals, as well as the risk and recharacterization proposals in Part I of the discussion draft.

BEPS Action 10: Discussion Draft on the Use of Profit Splits In the Context of Global Value Chains

This discussion draft addresses nine scenarios where one could argue it may be difficult to apply one-sided transfer pricing methods to benchmark the arm's-length range. The situations described include transactions where the parties to a transaction are highly integrated, sharing key functions and risks. In these situations, the draft notes that the transactional profit split method would reliably account for interdependence of functions and risks.

The draft asks 32 questions within these scenarios in order to solicit responses to understand when it may be more appropriate to use a transactional profit split method to ensure that transfer pricing outcomes are in line with value creation. Specifically, the draft seeks to understand how the existing guidance on the transactional profit split method, provided in Chapter II of the OECD Transfer Pricing Guidelines, is applied in practice. The comments received will be taken into account by the OECD in considering revisions to their guidance. The draft notes that the various views and proposals presented do not represent a consensus view of the OECD, but are intended to provide stakeholders with substantive proposals for analysis and comment.

The key topics on which comments are requested include, but are not limited to, the following:

- Understanding of how transfer pricing methods such as the transactional profit split methods apply to and address challenges posed by global value chains;
- Use of transactional profit split methods in dealing with hard-to-value intangibles results, unexpected results, and losses;
- How transactional profit split methods help achieve alignment between valuation creation and profits; and
- The correct scope for the application of transactional profit split methods.

BEPS Action 10: Discussion Draft on the Transfer Pricing Aspects of Cross-Border Commodity Transactions

This discussion draft discusses proposed additions to Chapter II of the OECD Transfer Pricing Guidelines. The first proposal involves adding guidance stating that the comparable uncontrolled price ("CUP") method would generally be the most appropriate transfer pricing method for commodity transactions. Under this proposal, the arm's-length price for the controlled commodity would be referenced to a quoted price. The logic behind this proposal is that, for transactions involving the sale or purchase of commodities, the quoted price (after any adjustments needed to account for comparability differences) will provide a reliable benchmark to determine if the price is arm's length. The guidance also proposes that, in

cases where there is an absence of evidence of the pricing date agreed to by the parties, the pricing date should be the shipment date of the commodities.

The discussion drafts discussed herein are not consensus documents (i.e., not all of the parties in the working groups that produced the drafts agree with all portions of the drafts). Written comments on the three drafts were due by February 6, and the OECD will hold a public consultation on these discussion drafts and other topics in Paris on March 19-20.

By Jessie L. Coleman, Washington, DC and Joshua Nixt, New York

IRS Releases Proposed Regulations on Research Credit for Internal Use Software

On January 20, 2015, the Treasury Department and the IRS published long-awaited proposed regulations under Code Section 41 (the “2015 Proposed Regulations”) addressing internal use software (“IUS”) as it relates to the credit for increasing research activities (the “research credit”). The 2015 Proposed Regulations follow an advance notice of proposed rulemaking that the Treasury Department and the IRS issued on January 2, 2004, seeking public comments to the proposed regulations on IUS that they published on December 26, 2001 (the “2001 Proposed Regulations”). Taxpayers are eligible for research credit in connection with expenditures for IUS only if taxpayers can establish that, in addition to meeting the general requirements for research credit eligibility, the IUS also meets certain additional requirements. The changes introduced by the 2015 Proposed Regulations are for the most part favorable for taxpayers because they narrow the circumstances in which software will be considered IUS and, in some cases, make it easier for taxpayers to meet the additional research credit eligibility requirements for IUS.

Section 41 provides that the amount of research credit available to a taxpayer is determined in part by the expenses incurred in connection with “qualified research.” Under the 2001 Proposed Regulations, any research with respect to computer software that is developed by (or for the benefit of) a taxpayer primarily for internal use by the taxpayer (i.e., IUS) is excluded from the scope of “qualified research” unless: (i) the IUS meets the general qualified research eligibility requirements under section 41(d)(1); (ii) the IUS is not otherwise excluded under section 41(d)(4) (other than section 41(d)(4)(E)); and (iii) the software meets one of the conditions set forth under Treasury Regulation section 1.41-4(c)(6). These conditions (as set out in the 2001 Proposed Regulations) require that: (i) the IUS be developed for use in an activity which constitutes qualified research; (ii) the IUS be developed for a production process with respect to which the general qualified research eligibility requirements are met; (iii) the software meet a “high threshold of innovation test”; or (iv) the software be developed together with hardware as a single product. The “high threshold of innovation test” of the 2001 Proposed Regulations requires taxpayers to establish that the software is innovative, that the development of the software involves significant economic risk, and that the software is not commercially available for use by the taxpayer.

As noted above, the 2015 Proposed Regulations narrow the definition of IUS. Under the 2001 Proposed Regulations, unless software was developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties, software was presumed to be IUS. However, whether software is held for sale may not be indicative of whether software is developed solely for “internal use”. Accordingly, the 2015 Proposed Regulations state that even if software is not developed to be commercially sold,

leased, licensed, or otherwise marketed to third parties, software is still not IUS if it is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. Examples of software that is not IUS would therefore now include software developed for third parties to execute banking transactions, track the progress of a delivery of goods, search a taxpayer's inventory for goods, store and retrieve a third party's digital files, purchase tickets for transportation or entertainment, or receive services over the Internet. Under the 2015 Proposed Regulations, software would be IUS if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business.

The 2015 Proposed Regulations also provide that IUS that enables a taxpayer to interact with third parties or to allow third parties to initiate functions or review data ("dual function computer software") is presumed to be IUS except to the extent that a taxpayer can identify a subset of elements of the dual-function computer software that cannot properly be characterized as IUS ("third-party subset"). There is also a safe harbor under which a taxpayer may include 25 percent of the qualified research expenditures of the remaining subset of dual- function software in computing the amount of the taxpayer's credit after excluding any third-party subset. The safe harbor is available only if use of the remaining subset by third parties or by the taxpayer to interact with third parties is reasonably anticipated to constitute at least 10 percent of this remaining subset's use.

The 2015 Proposed Regulations also modify the high threshold of innovation test. Unlike the 2001 Proposed Regulations, the 2015 Proposed Regulations no longer require that the taxpayer intend software to be unique or novel in order to be considered innovative. Instead, software is innovative if the software would result in a reduction in cost or improvement in speed or other measurable improvement that is substantial and economically significant. Also in contrast to the 2001 Proposed Regulations, the 2015 Proposed Regulations provide that the development of the software involves significant economic risk only if there is uncertainty related to the capability or methodology for developing or improving the software. Therefore, IUS research activities that involve only uncertainty related to appropriate design, and not capability or methodology, are not considered to involve significant economic risk. These changes to the high threshold of innovation test may make it easier for taxpayers to demonstrate that their IUS is innovative while at the same time make it more difficult for taxpayers to show that the development of their IUS involves significant economic risk.

The 2015 Proposed Regulations state that the IRS will not challenge return positions consistent with these regulations for taxable years ending on or after January 20, 2015. Taxpayers may therefore want to reexamine whether any of their ongoing or upcoming software expenditures may be eligible for research credit.

By Erik J. Christenson, San Francisco and Ian Yuon Siu, Palo Alto

New "No-Rule" Areas Announced by IRS - FATCA is Added to the International No-Rule List

On January 2, 2015, the IRS issued annual revenue procedures in the Internal Revenue Bulletin, which included its annual list of "no-rule" areas. Traditionally, the issues on which the IRS refrains from issuing letter rulings or determination letters tend to be inherently factual. In the domestic area, there are a number of modifications but no major additions to the no-rule list; in the international arena, however, the list was expanded to include Foreign Account Tax Compliance Act ("FATCA") issues.

International No-Rule Areas

In the international no-rule area, the IRS will "not ordinarily" rule on FATCA issues unless the taxpayer can establish "unique and compelling" reasons. This addition to the list is the only change made to the no-rule list of international issues. Under Rev. Proc. 2015-7, 2015-1 I.R.B. 231, the IRS will now not ordinarily rule on whether a taxpayer, withholding agent, or intermediary has properly applied the requirements of Chapter 4 of the Internal Revenue Code (Code Sections 1471 through 1474, also known as "FATCA") or of an applicable intergovernmental agreement to implement FATCA.

FATCA Basics

FATCA was enacted in 2010 in order to prevent tax evasion by US persons holding foreign assets or offshore accounts. Regulations enacted under FATCA require certain US taxpayers holding offshore financial assets to report such assets to the IRS by submitting Form 8938, Statement of Specified Foreign Financial Assets.

Specifically, Code Section 6038D(a) requires any individual who holds any interest in specified foreign financial assets that are worth $50,000 or more in aggregate to report information about those assets. Code Section 6038D(b) defines the term "specified foreign financial asset" to mean any financial account maintained by a foreign financial institution, and any foreign asset that are not held in an account maintained by a financial institution. Reporting applies for assets held in taxable years beginning after March 18, 2010. Under Code Section 6038D(c), if a specified foreign financial asset that is being disclosed is a foreign account, the US taxpayer must disclose the name and address of the financial institution in which such foreign account is maintained and the account number and the maximum value of the asset during the taxable year. With respect to any stock, security, or any other instrument, the name and address of the issuer and such information as is necessary to identify the instrument or class of which such stock or security is a part are required to be disclosed. Failure to comply with the foregoing rules results in a penalty of $10,000, and there may additional penalty if an individual fails to furnish the required information after receiving a notice of such failure from the IRS.

Chapter 4 Requirements Imposed on FFIs

Chapter 4 of the Code further provides obligations imposed on foreign financial institutions ("FFI") under FATCA. In order to avoid being withheld upon, FFIs may register with the IRS and agree to report to the IRS certain information regarding financial accounts held by US taxpayers or by foreign entities in which US taxpayers hold a substantial ownership interest.

Code Section 1471(a) requires any withholding agent to withhold 30% of any withholdable payment to a FFI, unless such payment meets the requirements of section 1471(b). For this purpose, section 1471(d)(5) defines the term "financial institution" to include any entity that accepts deposits in the ordinary course of a banking or similar business, holds financial assets for the account of others as a substantial portion of its business, or is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in the foregoing. In order to meet the requirements, unless other exceptions provided under the Code are applicable, an FFI must enter into an agreement with the IRS to fulfil certain obligations such as obtaining relevant information regarding each account holder and complying with due diligence procedures. Under sections 1471(b)(1)(C) and (E), an FFI must furnish the relevant information with respect to accounts held by US taxpayers to the IRS on an annual basis and any additional information as requested by the IRS. Relevant information that the IRS may require an FFI to report under the agreement includes personal information of each account holder (a US taxpayer), the account number, and the balance, as prescribed by section 1471(c)(1). Perhaps because any inquiry regarding compliance with the above requirements is likely to be very fact specific, the IRS will not rule on whether a taxpayer, withholding agent, or intermediary has properly applied the Chapter 4 requirements, absent "unique and compelling" reasons that must be established by the taxpayer.

Domestic No-Rule Area

Under Rev. Proc. 2015-3, 2015-1 I.R.B. 129, there are two categories of issues on which the IRS will not issue letter rulings or determination letters. Section 3 lists those areas in which rulings or determination letters will not be issued. Section 4 sets forth those areas in which rulings or determination letters will "not ordinarily" be issued. "Not ordinarily" means that unique and compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter. This year, there were no major changes to the overall list of no-rule items. However, two issues with respect to the termination of a charitable remainder trust were moved from section 4 to section 3, meaning that the IRS will not issue private letter rulings or determination letters on this matter. The first issue is whether, upon the termination of a charitable remainder trust, the deemed sale of a term interest is the sale of a capital asset defined under Code Section 1221, and the second issue is the determination of amount of, and recognition of, gain or loss upon termination of a charitable remainder trust.

Charitable Remainder Trusts and Early Termination

A charitable remainder trust is defined by Code Section 664(d)(1) as a trust from which a certain amount of money is transferred to individual beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest held for the benefit of, or paid over to, charity. Generally, a charitable remainder trust is not subject to income tax, which is why it is a commonly used tax-deferral tool. Naturally, there has been an increasing interest in early termination of such charitable remainder trusts, and the IRS has issued several private letter rulings that discuss the income tax treatment of the termination. For planning purposes, a common federal income tax question that arises upon an early termination of the trust is whether a beneficiary may receive proceeds equal to his interest in the trust free of capital gains tax.

Generally, Code Section 1001(e) governs the determination of gain or loss from the sale or disposition of a term interest in property, such as a life or term interest in a charitable remainder trust. This particular code section was enacted to address trust terminations. Furthermore, Code Section 1221(a) defines a capital

asset as property held by a taxpayer with certain exceptions, which do not include a term interest. In previously issued rulings, the IRS has taken the position that a term interest in a charitable remainder trust is a capital asset on the rationale that the right to receive income from a trust is equivalent to a right in the trust itself.

The reason that the IRS has consistently taken the position that it will no longer rule on the amount of gain or loss upon termination of a charitable remainder trust and characterization of the deemed sale of a term interest may be that it has become aware of the complicated and controversial nature of early termination cases of charitable remainder trusts.

By Sophia Han, New York

CCA 201501013 - Offshore Private Fund's US Trade or Business

The IRS Office of Associate Chief Counsel (International) recently issued CCA 201501013 (the "CCA"), in which they concluded that the activities of an offshore fund manager with a US office (the "Fund Manager") should be attributed to a private fund (the "Fund"). As a result, the IRS found that the Fund was engaged in a US trade or business. The IRS further concluded that the Fund's underwriting and lending activities were not eligible for the stock and security trading safe harbors of Code Section 864(b)(2)(A) ("Trading Safe Harbors"), as the IRS found it was engaged in an active lending business. The effect of the IRS's conclusions was that any foreign investor of the Fund would be subject to US federal income tax, and where the foreign investor was a foreign corporation, possibly also a 30% branch profits tax.

The CCA addresses what appears to be a typical offshore private fund structure. The Fund at issue in year one was organized as a US limited partnership and then, in year two, converted to a foreign partnership. The CCA mentions that one of the limited partners of the Fund was a foreign feeder fund, organized as a foreign corporation (the "Foreign Feeder"). It is this Foreign Feeder that presumably would be subject to tax on the Fund's effectively connected income. Presumably, the Foreign Feeder would serve as a blocker corporation through which the foreign investors would invest. The Foreign Feeder was the only limited partner of the Fund that was mentioned in the CCA.

The Fund had no employees and conducted all of its activities through the Fund Manager. The Fund Manager conducted the activities primarily through an office in the United States. The Fund Manager did not work exclusively for the Fund, as it also provided similar services to other investment entities. The Fund Manager employed numerous employees in the US, and no employee worked exclusively for the Fund.

The Fund engaged the Fund Manager as an investment manager pursuant to a management agreement and appointed the Fund Manager as its "agent and irrevocable attorney in fact with full power to buy, sell, and otherwise deal in securities and related contracts for Fund's account… and [t]he full power and authority to do and perform every act necessary and proper to be done as fully as Fund might or could do personally." Pursuant to this grant of authority, the Fund, through the Fund Manager, engaged in lending transactions and stock distribution (i.e. underwriting) activities.

With regard to the lending activities, the Fund, through the Fund Manager, negotiated with unrelated borrowers concerning all key terms of the loans, conducted extensive due diligence on potential borrowers, lent them money, and obtained discount conversion prices or warrants with its loans. The loans were mostly convertible debts and promissory notes. Typically, the conversion prices for converting the loans to equity were discounted from the trading price for the stock. This spread was possible as a result of the loan negotiations. The Fund would immediately sell the shares after exercising a conversion right, earning a spread by quickly disposing of the stock. In addition, the Fund received various fees from the borrowers. The CCA did not elaborate on the number of loans made by the Fund in the years at issue. It also did not provide any details as to loan amounts.

With regard to the underwriting activities, the Fund, through the Fund Manager, underwrote the shares of US companies for sale to both US and foreign customers. The Fund Manager negotiated the terms of these agreements directly with the issuers. The issuers had to register with the SEC so that the Fund could sell the shares into the US market and pay the advances requested by the issuers. The Fund would make money on the spread of the shares sold (because the Fund purchased the shares at a discounted price below the stock's market value). The Fund also earned fees for commitment, structuring, and due diligence.

IRS's Three Conclusions

Based on the foregoing facts, the IRS reached three conclusions.

1 - The Fund was Engaged in a US Trade or Business

The IRS found that the Fund was engaged in a US trade or business. Because the Fund Manager was the Fund's legal agent under the management agreement, the IRS found that the US activities of the Fund Manager were attributable to the Fund. Relying on the general case law and authority that the activities of an agent are attributable to the principal, and given the Fund Manager's "full power and authority to do and perform every act necessary and proper to be done as fully as Fund might or could do personally," the IRS found that the activities of the Fund Manager should be attributed to the Fund. Second, the IRS, citing to *De Amodio v. Commissioner*, 34 TC 894 (1960), found that the activities of the Fund were "considerable, continuous and regular" where the Fund made loans to unrelated borrowers, entered into various Distribution Agreements, actively solicited potential borrowers and issuers, negotiated with counterparties, and performed extensive due diligence.

2 - The Fund's Activities Were Not the "Trading in Stocks or Securities" Within the Meaning of the Trading Safe Harbors

The IRS found that the Fund's lending and stock underwriting activities were not the "trading in stocks or securities" within the meaning of the "Trading Safe Harbors." First, the IRS found that because the Fund was actively soliciting unrelated borrowers in the US and made a number of loans, the Fund was engaged in the active conduct of a banking, financing, or similar business. The IRS, without elaborating, concluded that the loans to the unrelated parties were loans to the public, and was likewise silent on the number of loans that created this lending business.

Second, the IRS found that the Fund's underwriting activities did not fit within the limited underwriting exception of Treasury Regulation Section 1.864-2(c)(2)(iv)(b)(1), which provides that a foreign underwriter will not be treated as

engaged in a US trade or business where they act as an underwriter for the purpose of making a distribution of stocks or securities of a US issuer only to foreign purchasers. The IRS found that, because the Fund also sold the shares to US purchasers, it did not meet this limited exception.

Third, the IRS took the position that the Fund's resale of the securities obtained at a discount (whether through its lending activities or its underwriting activities) would not qualify as securities trading because it profited from its activities by earning fees, interests, and a spread, and not pure market appreciation as is typically how traders earn money. Rather, the Fund was acting as a dealer in the securities.

3 - Even if the Fund's Activities Were "Trading in Stocks or Securities," Neither of the Two Trading Safe-Harbor Exceptions Would Apply

The IRS concluded that even if the Fund's lending and stock underwriting activities were "trading in stocks or securities" for the purposes of the Trading Safe Harbors, neither of the two exceptions would apply. Had one of the two Trading Safe Harbors applied, the Fund's trading could have been exempted as a US trade or business.

The first exception exempts trading as a US trade or business when trading through a US broker, commission agent, custodian, or other independent agent. A grant of discretionary authority to the US broker will cause the foreign taxpayer to fall outside of this exception. The IRS found that the Fund was not eligible for this exception because the Fund had no employees of its own and instead conducted its business entirely through the Fund Manager, which had discretionary authority.

The second exception exempts trading in securities for the taxpayer's own account as a US trade or business, regardless, whether the trader uses a US broker or its employees and regardless of whether its agent has discretionary authority, provided that the taxpayer is not a dealer. Thus, while this exception does permit the grant of discretionary authority, it is not available for dealers. The Treasury Regulations under section 864 define a dealer as a "merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom." The IRS concluded that the Fund was a dealer because it was purchasing the shares as a merchant as indicated in the above definition and as underwriters typically do, and selling the shares into the US market. The regulations provide two narrow exceptions to the definition of "dealer", and the Fund did not fit into either. The first exception would apply if the Fund were not selling to US customers, even if another member in the group were selling to US customers. Because the Fund was selling to US customers, this exception did not apply. The second exception likewise did not apply, as the Fund was not trading for customers that were not themselves dealers, investment partnerships, or foreign corporations.

Thus, based on the above, the IRS concluded that the Fund was engaged in a US trade or business and was engaged in a lending and underwriting business. The Foreign Feeder, as a limited partner in the Fund, was deemed to be engaged in a US trade or business.

The CCA is not law and merely represents the IRS's position. However, it is a reminder that the trading exception generally does not extend to the activities of lenders and securities dealers.

By Cecilia B. Hassan, Miami

Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698

On February 3, 2015, the State Administration of Taxation ("SAT") of China issued the long-awaited Indirect Transfer Regulation (i.e., SAT Bulletin No. 7), replacing the well-known Notice 698. The Indirect Transfer Regulation expands the scope of application to cover indirect transfers of : (i) the property of an "establishment or place," and (ii) real property situated in China, in addition to the indirect transfer of equity interests in Chinese resident enterprises. This expansion is significant because the Regulation could potentially apply to any multinational enterprises ("MNEs") that indirectly hold any assets in China.

It is a mixed bag in terms of what this Regulation means to MNEs that have to deal with it. The regulation provides some safe harbors, notably the internal reorganization exemption, but also authorizes tax authorities to directly determine, without going through holistic review, the lack of reasonable commercial purpose under certain circumstances. It no longer requires mandatory reporting, but imposes a withholding obligation on offshore buyers, with the intention to collect the same amount of revenue from the buyer if the seller fails to pay its tax.

The Regulation will have significant influence not only on how cross-border M&A deals are negotiated and conducted in China going forward, but also on existing, open tax positions on indirect transfers that have occurred since 2008. Going forward, there will certainly be to-dos and not-to-dos in negotiation and contract drafting for transactions, and in dealing with the tax authorities.

For more information, see the February 2015 Baker & McKenzie China Tax Client Alert, *Breaking News: China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698*, also available under publications at www.bakermckenzie.com.

By Shanwu Yuan, New York

China Releases its 2013 APA Annual Report

On December 5, 2014, the State Administration of Taxation ("SAT") released the *2013 China Advance Pricing Arrangement* ("APA") *Annual Report* ("Annual Report"). This fifth annual report focuses on China's APA mechanisms, procedures, and practices, and provides statistics for 2005 through 2013, accompanied by an analysis of the statistics. The Annual Report came after the SAT declared publicly in September 2014 that it would suspend APA negotiations with treaty partners through 2015. Many had anticipated that the SAT would delay publishing its annual report as well because the SAT is short handed. The release of the Annual Report, although later than the customary target date of July 1, shows that the SAT is still committed to the APA program, and that the suspension is only temporary.

It is expected that the SAT will turn its attention back to the APA program in September 2015. The fewer bilateral APAs executed in 2013 compared to the number 2012 is attributable, in part, to the limited personnel and resources that the SAT has available to deal with bilateral APAs. That being said, the SAT is currently evaluating the creation of a separate division to deal with mutual agreement procedures for transfer pricing issues. Once that division is created, more resources would be devoted to the APA program, and the length of time it takes to conclude an APA may be reduced.

For a more detailed discussion, see the January 2015 Baker & McKenzie Tax Client Alert, *China Releases its 2013 APA Annual Report,* also available under publications at www.bakermckenzie.com.

The UK Diverted Profits Tax - A Summary

The UK government recently published its draft legislation on the new diverted profits tax ("DPT"). The tax, which will take effect on April 1, 2015, is designed to counteract arrangements that would otherwise erode the UK tax base and to encourage groups to ensure that profits are taxed where the related substance is located.

Although the DPT has been referred to in the media as the "Google Tax", its scope is not limited to technology companies. In fact, the DPT can potentially apply (at a rate of 25%) to a broad range of companies and fact patterns. For a more detailed discussion, *see* James Wilson's *The UK Diverted Profits Tax - A Summary*, (December 2014).

By James A.D. Wilson, London/New York

Canadian Tax Update

Multinationals with Canadian activities should take note of the following recent developments:

CRA Denies Tax Refund Request of a Non-Resident Carrying on Business in Canada

The Canadian Income Tax Act mandates the Canada Revenue Agency ("CRA") to refund any overpaid tax, interest, and penalties if the taxpayer has filed its tax return within three years of the end of the taxation year in question, and the taxpayer requests its refund during the period in which the CRA can reassess the taxpayer for that year.

The Canadian Income Tax Act also provides that a non-resident corporation carrying on business in Canada at any time in a taxation year is required to file, subject to narrow exceptions, a Canadian income tax return in respect of the taxation year. This obligation exists even if the non-resident corporation does not carry on business in Canada through a permanent establishment situated in Canada, such that its business profits are not subject to income tax in Canada by virtue of a tax treaty.

The interaction of these rules was addressed by the CRA in a recently released letter (doc 2014-0538901E5). At issue was a situation in which a non-resident corporation ("NRCo") carried on business in Canada, but did not file a Canadian income tax return. The CRA assessed NRCo on the basis that it carried on business in Canada and owed Canadian income tax. To mitigate against the interest that would accrue in the event that the CRA was correct about NRCo's tax liability, NRCo paid the full amount of the tax that was assessed against it by the CRA. NRCo objected to the assessment and was ultimately successful in convincing the CRA that it was not carrying on business in Canada through a permanent establishment situated in Canada and therefore, was not subject to Canadian income tax. Notwithstanding NRCo's success, the CRA refused to refund the amount paid by NRCo because NRCo had filed its tax returns more than three years after the end of the applicable taxation year.

It appears from the letter that NRCo made the tax payment voluntarily. Notably, however, if NRCo had been a "large corporation" (generally, where taxable capital in Canada of the corporate group exceeds $10 million), the CRA would have been entitled to take collection action against NRCo for 50% of the amount in dispute. It seems especially egregious that the CRA could enforce collection against a taxpayer for 50% of the amount in dispute and then, once the taxpayer is ultimately found not to owe the tax, refuse to refund the overpayment to the taxpayer.

As for remedies, the letter does not address NRCo's available options. Presumably, these would include bringing a lawsuit against the CRA for unjust enrichment, making an application to court for judicial review of the CRA's refusal, or making an application to the government for a tax remission order. In our view, anything short of a full refund would appear to be unjust.

Canadian Customs Announces New Policy Regarding Retroactive Transfer Price Adjustments

The Canada Border Services Agency (the "CBSA") has changed its long-standing policy and announced that a retroactive transfer price adjustment resulting in a reduction of the price paid or payable for imported goods may entitle an importer to a refund of duties paid (provided the adjustment is made in accordance with a written agreement in effect at the time of importation). This announcement was made in Customs Notice 15-001, *Treatment of Downward Price Adjustments in Value for Duty Calculations*. Before this change in policy, the CBSA's position was that retroactive transfer price increases resulted in an obligation to correct the value for duty originally declared, but retroactive transfer price reductions could not be taken into account (and therefore importers were precluded from obtaining refunds). This change of policy presents a potential for significant duty recovery, given that an importer may file a refund claim within four years of the importation subject to the claim. For additional details regarding this change of policy, see the Client Alert, *Canada Customs Announces New Policy Regarding Retroactive Transfer Price Adjustments*, prepared by our Global International Trade Compliance and Customs Practice.

New Form for The Excise Tax Act Section 156 Election Now Available

In the December 2014 Canadian Tax Update, we noted the new filing requirement for closely related corporations and partnerships that make the election under section 156 of the Excise Tax Act (the "ETA"). The section 156 election generally deems supplies of property and services between eligible closely related corporations and partnerships to be made for nil consideration so that intercompany supplies generally will not be subject to goods and services tax/harmonized sales tax ("GST/HST"). The filing requirement applies to closely related corporations and partnerships entering into new section 156 elections on or after January 1, 2015 and closely related corporations and partnerships that wish to have section 156 elections made prior to 2015 remain in effect after January 1, 2015. The election forms have now been released and are available at the following link on the CRA web site: http://www.cra-arc.gc.ca/E/pbg/gf/rc4616/rc4616-fill-14e.pdf.

The Right to Claim Input Tax Credits Not Subject to Enhanced Burden of Proof

Revenu Québec, which administers the GST in Québec, has encountered widespread fraud involving false invoices and “invoices of convenience” in the construction, scrap metal, and employment agency (“EA”) industries. For example, we understand that in the EA industry, there have been cases where an EA registered for, and charged its customers, GST on the supply of temporary workers; the EA’s customer paid the GST to the EA and claimed input tax credits (“ITCs”) to recover the tax paid; and then the EA absconded with the GST collected. Ultimately, cases of this sort left Revenu Québec out of pocket. The same problem applies for Québec Sales Tax (“QST”) purposes, a provincial value-added tax that applies in Québec in the same general manner as the GST.

In an effort to combat this fraud, Revenu Québec began imposing stringent supplier-verification obligations on customers of EAs who sought to claim ITCs to recover the tax paid to the EAs. Specifically, in addition to the documentary requirements imposed under subsection 169(4) of the ETA, Revenu Québec has required that customers of an EA confirm the EA’s legitimacy through different measures, including: verifying the supplier’s legal existence with the corporate registrar, visiting the supplier’s head office for proof that actual commercial activities were taking place, asking all the EA’s temporary employees to provide identification and their Social Insurance Numbers and obtaining compliance letters from the provincial occupational health and safety agency confirming that the hours worked by the EA’s employees were reported.

The validity of these Revenu Quebec requirements was recently considered by the Federal Court of Appeal (“FCA”) in *The Queen v. Salaison Lévesque Inc.*, 2014 FCA 296. The FCA upheld the judgment of the Tax Court of Canada (“TCC”) allowing Salaison Lévesque Inc.’s (“Salaison”) appeal of Revenu Quebec’s disallowance of ITCs claimed in respect of GST paid to EAs notwithstanding Salaison’s failure to comply with Revenu Quebec’s enhanced supplier-verification obligations. To the relief of taxpayers, the FCA effectively agreed with the TCC’s holding that ITC claims will be considered valid where there is a legitimate supply made, the customer has paid the tax, and the customer satisfies the documentary requirements under subsection 169(4) of the ETA. That is, it is not within the power of Revenu Québec to impose on taxpayers enhanced supplier-verification obligations that fall outside the ETA.

While Salaison addressed Revenu Québec’s audit practices, it is important to note that the CRA has been grappling with similar fraud issues and considering the level of due diligence that it will impose on persons claiming ITCs under its jurisdiction. However, given the decision in Salaison, it would appear that where the underlying transaction is legitimate and there is no obvious basis for the customer to question the supplier’s legitimacy, the customer should be entitled to claim ITCs provided it satisfies the ETA’s documentary requirements. Revenu Québec has not appealed the FCA decision as of the date of writing.

By Alex Pankratz, Toronto and Randy Schwartz, Toronto

Finding Fair Apportionment in South Carolina is a Burden

On December 23, 2014, the South Carolina Supreme Court issued its decision in *CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, Opinion No. 27474, holding that where a party seeks to deviate from South Carolina's statutory apportionment method, the proponent of such alternative apportionment method bears the burden of proving by a preponderance of the evidence that: (1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina; and (2) its alternative apportionment method is reasonable. The court found that the South Carolina Department of Revenue ("Department"), the proponent of the alternative apportionment method in this case, had not carried its burden of proof, resulting in a taxpayer victory. This decision modified and affirmed the decision of the South Carolina Court of Appeals, which had ruled that the alternative-apportionment proponent bears not only the burden of proving that the statutory formula does not fairly represent the taxpayer's business activity in South Carolina, but also the burden of proving that the alternative method is more appropriate than any other competing apportionment method. The South Carolina Supreme Court's modification to the Court of Appeals decision clarified the conditions under which alternative apportionment may be obtained in South Carolina.

CarMax, Inc. ("CarMax"), a used automobile retailer, operated its retail stores through two subsidiaries: (1) CarMax Auto Superstores West Coast, Inc. ("CarMax West"), which operated CarMax retail stores throughout the western United States; and (2) CarMax Auto Superstores, Inc. ("CarMax East"), which operated CarMax retail stores throughout the eastern United States. From 2002 to 2004, CarMax West owned substantially all of CarMax's intellectual property and licensed it to CarMax East in exchange for royalties. CarMax East managed all of the financial operations and corporate overhead for CarMax.

In 2004, CarMax reorganized to centralize various corporate and financing services and intellectual property management functions in CarMax Business Services, LLC ("CBS"), a limited liability company owned by CarMax West, a 93.5% member, and CarMax East, a 6.5% member. Following the restructuring, the role of CarMax East and CarMax West was limited to retailing, and CBS provided corporate overhead services and certain financing services. CBS charged CarMax West and CarMax East a per vehicle management fee which included an intellectual property management component. Both CarMax East and CarMax West received distributive share income from CBS, an entity classified as a partnership for federal income tax purposes, but, unlike CarMax East, CarMax West's financial connection to South Carolina from 2005-2007 was limited to the distributive share of income that it received from CBS. Similarly, from 2002-2004, CarMax West's financial connection to South Carolina was limited to the royalties it received from CarMax East.

From 2002-2007 ("Period at Issue"), South Carolina corporate taxpayers were generally required to apportion their income using a three-factor apportionment formula, which consisted of a property factor, a payroll factor, and a double-weighted sales factor. CarMax West initially filed South Carolina corporate income tax returns in this manner for the Period at Issue, and, after being audited and assessed by the Department, CarMax West filed amended South Carolina corporate income tax returns using a single-sales factor apportionment formula ("Gross Receipts Method") that was statutorily provided for corporate taxpayers that principally derived income from sources other than tangible personal property

and that did not belong to certain enumerated industries not applicable to CarMax (e.g., pipelines, airlines, railways, etc.). CarMax West's sales factor pursuant to the Gross Receipts Method was computed by dividing its South Carolina receipts by its overall gross receipts, including its gross receipts from its automobile retail operations, derived from everywhere it conducted business.

The Department rejected CarMax West's use of the Gross Receipts Method and proposed to employ an alternative apportionment method. The Department's proposed alternative apportionment method was similar to the Gross Receipts Method, except it excluded CarMax West's retail sales receipts from the denominator of the sales factor. The Department issued a Final Agency Determination upholding its alternative apportionment method position, and, after CarMax West appealed to the South Carolina Administrative Law Court ("ALC"), the ALC upheld the Department's alternative apportionment method. In making its determination, the ALC held that ". . . [t]he standard of proof is a preponderance of the evidence. [Internal cite omitted.] Additionally, the burden of proof is generally upon the party asserting the affirmative in an adjudicatory administrative proceeding. 2 Am. Jur. 2d Administrative Law § 354 (2004). The taxpayer in this matter requested a contested case hearing to challenge the Department's proposed assessment; thus the taxpayer bears the burden of proof."

South Carolina Court of Appeals Decision

On appeal, CarMax West alleged that the ALC erred in failing to place the burden of proof on the Department to establish by clear and convincing evidence that the standard statutory apportionment method used by CarMax West did not reflect the extent of CarMax West's business in South Carolina. CarMax West acknowledged that the burden of proof in tax cases generally falls on the petitioner, with the evidentiary standard of proof being a preponderance of the evidence. With respect to alternative apportionment cases, however, CarMax West argued that the burden shifts to the party seeking to invoke alternative apportionment. In addition, CarMax West implored the court to adopt a "clear and convincing" standard of proof, citing to various cases from other jurisdictions as support. In response, the Department agreed that it had the initial burden of proving that CarMax West's chosen method of apportionment was unreasonable; however, once that burden was met, the Department argued that the burden shifted to CarMax West to prove by clear and convincing evidence that the Department's alternate method leads to a "grossly distorted" result.

The Court of Appeals, relying on *Media General Commc'ns, Inc. v. South Carolina Dep't of Revenue*, 694 S.E.2d 252 (S.C. 2010), reversed the ALC's decision on the issue of which party bears the burden of proof in alternative apportionment cases. The court stated that the proponent of alternative- apportionment must establish (1) that the statutory formula does not fairly represent the taxpayer's activity in the state, and (2) that its alternative method is reasonable and not only appropriate, but more appropriate than any competing methods. With respect to the evidentiary standard, however, the Court of Appeals declined to adopt a clear-and-convincing standard. The court held that "CarMax West . . . failed to cite any South Carolina authority supporting its position and the statutes do not indicate a legislative intent to apply the clear and convincing standard." As such, the Court of Appeals reversed the ALC's determination that CarMax West had the burden of proof and remanded the case to the ALC for reconsideration applying the preponderance-of-the-evidence standard. The parties each filed petitions for a writ of certiorari with the South Carolina Supreme Court, with the Department appealing the alternative- apportionment burden of proof standard adopted by the Court of Appeals.

South Carolina Supreme Court Decision

On appeal, the South Carolina Supreme Court agreed with the Court of Appeals that the application of alternative apportionment requires a two-part inquiry. Although the Supreme Court agreed that the first prong can be met if the proponent demonstrates by a preponderance of the evidence that the statutory formula does not fairly represent the taxpayer's business activity in South Carolina, the Supreme Court took issue with the Court of Appeals' articulation of the second prong, which required the proponent to establish that its alternative apportionment method is more appropriate than any competing methods.

In reviewing the second prong, the Supreme Court noted that the Court of Appeals had misapplied *Media General*. The Supreme Court distinguished this case from *Media General*, noting that the parties in *Media General* agreed that the statutory alternative method did not fairly reflect the taxpayer's business in South Carolina. In such circumstance, a situation arises where either party could propose an alternative apportionment method for comparison and consideration. In contrast, in a situation where only one party is seeking to deviate from the statutory formula, the Supreme Court held that, after demonstrating that the statutory formula does not fairly represent a taxpayer's business activity in the state, the proponent of alternative apportionment is only required to prove that its proposed alternative apportionment method is reasonable. Notwithstanding its correction of the second prong of the two-part test, the Supreme Court ruled in favor of CarMax West after finding that the Department had not satisfied the first prong of the two-part test by failing to prove that the statutory formula did not fairly represent CarMax West's South Carolina business activity.

The South Carolina Supreme Court's modification to the alternative-apportionment test set forth by the Court of Appeals is significant in that it provides guidance for obtaining alternative apportionment, which is a result that both taxpayers and the Department may seek. While proving that the statutory formula is not fairly representative of the taxpayer's in-state business activities may be a significant challenge, the challenge of proving that an alternative apportionment method is more appropriate than any competing method, as proposed by the Court of Appeals, would likely have been exceedingly difficult, as it could require the consideration of all such competing methods. The South Carolina Supreme Court's modification relaxes the Court of Appeals' proposed standard, takes a more practical approach to the administration of alternative apportionment, and provides the parties applying for, or defending against, alternative apportionment with a framework to evaluate the potential outcome.

By John Paek, Palo Alto and Michael C. Tedesco, New York

Michigan Multistate Tax Compact Update: Michigan Court of Claims Upholds the Retroactive Repeal of the Multistate Tax Compact in *Yaskawa* and *Ingram Micro*

On December 19, 2014, the Michigan Court of Claims upheld the retroactive repeal of the Multistate Tax Compact ("Compact") in *Yaskawa America Inc. v. Dep't of Treasury*, Case No. 11-000077-MT (Mich. Ct of Claims 2014), and *Ingram Micro Inc. v. Dep't of Treasury*, Case No. 11-000035-MT (Mich. Ct of Claims 2014). To briefly recap the significance of this developing issue, the Michigan Supreme Court ruled in favor of the taxpayer in *IBM v. Dep't of Treasury*, 852 NW2d 865 (Mich. 2014), holding that IBM was entitled to elect the Compact's three-factor apportionment-formula under the Michigan Business Tax Act ("MBT") instead of the single-sales factor formula provided by the MBT for tax year ending 2008. In response to *IBM* and anticipating the potential payment of over $1 billion in MBT refunds claimed pursuant to *IBM*, Michigan enacted Public Act 282 of 2014 to repeal the Compact in its entirety, retroactive to January 1, 2008. For previous updates on Public Act 282, please refer to prior Tax News and Developments articles *Never a Dull Moment…Michigan Seeks to Re-Write History By Retroactive Repeal of the Multistate Tax Compact* , October 2014 and *Ready for Another Round? Michigan's Second Retroactive Repeal of the Multistate Tax Compact Election*, December 2014, available under publications at www.bakermckenzie.com.

Shortly following enactment of Public Act 282 in September 2014, Michigan courts addressing taxpayers' ability to elect the Compact's apportionment formula were faced with a number of questions associated with the Compact's retroactive repeal, including questions of due process, separation of powers, and the nature of the Compact itself. In the first published decisions directly addressing these issues, the Michigan Court of Claims upheld Public Act 282 in *Yaskawa* and *Ingram Micro*, finding that the Compact is not a binding contract and that Public Act 282 is a valid, constitutional act that does not violate the principle of separation of powers under the Michigan constitution. It has been widely reported that, following *Yaskawa* and *Ingram Micro*, 54 cases involving MBT refund claims based on the Compact election were dismissed by the Court of Claims.

While the Court of Claims made its initial position clear, the Compact issues related to Public Act 282 seem far from final resolution. On February 4, 2015, IBM, in a related Compact election case involving its 2010 tax year (as distinguished from the Michigan Supreme Court case involving IBM's 2008 tax year), filed a motion with the Michigan Court of Appeals to consolidate with 33 closely related cases also involving the Compact's three-factor apportionment formula and Public Act 282 and remand to the Court of Claims for further development of the factual record. If the motion is granted, the taxpayers may have an opportunity to further develop the factual record regarding Michigan's involvement with the Multistate Tax Commission since 2008 and other related issues.

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Save the Dates: Baker & McKenzie's North American Tax Group Announces Spring Global Tax and Transfer Pricing Conference Dates

Whether you want to stay informed on the latest tax updates or just need a break from the winter blues, Baker & McKenzie is pleased to invite you to the following upcoming international tax and transfer pricing events taking place this spring. Our Latin American Tax Practice starts the spring conference line up in Miami, March 17-19, for the ***16th Annual Latin American Tax Conference***. Shortly thereafter, Baker & McKenzie and Bloomberg BNA will hold their annual ***Global Transfer Pricing Conference*** in Paris on March 30-31 and in Washington, DC on June 11-12. Also returning to New York for the fifth consecutive year, the ***12th Annual Global Tax Planning and Transactions Workshop*** will take place on April 29-30. Each program is designed to keep clients and friends of the Firm informed of the latest tax legislative developments and issues affecting multinational corporations today.

16th Annual Latin American Tax Conference in Miami

The ***16th Annual Latin American Tax Conference*** will take place from March 17-19 at the Four Seasons Hotel in Miami, Florida. This event will provide a truly global perspective, with tax representatives from Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, the US and several key European jurisdictions. Presenters will take an in-depth approach as they delve into the most current and challenging tax issues affecting businesses and industries throughout Latin America. Complete conference details, agenda and registration information can be accessed at www.bakermckenzie.com/eventlaannualtaxconferencemar15.

Baker & McKenzie / Bloomberg BNA Global Transfer Pricing Conferences

With the BEPS project in full swing, Baker & McKenzie teams with Bloomberg BNA to offer their third annual ***Global Transfer Pricing Conference*** in Paris (March 30-31) immediately following the OECD Global Forum on Transfer Pricing. This international conference will join OECD and government officials, along with Baker & McKenzie Transfer Pricing practitioners and esteemed corporate representatives to provide attendees a first-hand look into how countries are responding to the BEPS Project and the legislative changes they are enacting in response to BEPS concerns. Conference sessions will focus on the BEPS Action Plans and the effect the Action items are having on such issues as information exchanges, tax treaties and dispute resolution, and country-by-country reporting. Baker & McKenzie's global transfer pricing practitioners will moderate the conference panel sessions which are designed to create an interactive dialogue between the government, corporate and private practice panelists. Full conference details, agenda and registration information is accessible at the event's web page at go.bna.com/global-transfer-conference. Special early bird pricing ends Friday, February 20.

Save the date as well for the Washington, DC ***Global Transfer Pricing Conference*** which will be held June 11-12, directly after the joint OECD and USCIB Conference. Similar to previous years, the conference will include the latest thinking from government, corporate and private practitioners on recent transfer pricing issues. Registration and agenda information will be available

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soon, full information on the event can be found at go.bna.com/transfer-pricing-conference-primer.

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

Returning to the city that never sleeps, Baker & McKenzie's annual *Global Tax Planning and Transactions Workshop*, ***The BEPS Project - A Game Changer for Tax Planning and Transactions***, will take place at the Crowne Plaza Times Square on Wednesday, April 29 and Thursday, April 30. This premier event transforms this year into a two-day Workshop in order to accommodate the wide range of current topics relating to the BEPS Project and its effect on the current tax landscape. Breakout sessions will center around four key tracks: Global Tax Planning and Transfer Pricing, Tax Planning 101 - Understanding the Basics, Global M&A and Business Restructuring, and Developments in Latin America, Europe and Asia. In addition to the Workshop, interested companies have the opportunity to meet privately with Baker & McKenzie tax practitioners from around the globe on Wednesday morning, April 29 to discuss issues of current concern. To view full conference details, agenda and registration information, please visit the event's web page at www.bakermckenzie.com/eventnataxplanningworkshopapr15.

We hope to see you at one or more of our upcoming spring events! General CLE and CPE credits are available for each, a uniform certificate will be provided upon request for participants to use for credit applications. The North American Tax Practice Group continuously works toward offering timely events on a number of various tax topics, please refer to the Upcoming Events listing in this newsletter for future event announcements, your in-box for our event invitations, our events web page at www.bakermckenzie.com/tax/event or contact us directly at TaxNews@bakermckenzie.com if you are interested in a specific event.

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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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