Tax News and Developments

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Tax Court Invalidates Treasury Regulation in *Altera*

On July 27, 2015, the Tax Court ruled in favor of the taxpayer in *Altera Corporation & Subsidiaries v. Commissioner*, 145 T.C. No. 3, slip op. (2015), and invalidated a Treasury Regulation that had been promulgated under Code Section 482. Treas. Reg. § 1.482-7(d)(2) (2003) (the "Final Rule") required controlled participants in a qualified cost sharing arrangement ("QCSA") to include amounts attributable to stock-based compensation in the cost pool. The Tax Court, sitting in conference, held that the Final Rule failed to satisfy the reasoned decisionmaking standard in *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Auto Insurance Co.*, 463 U.S. 29 (1983), and was therefore invalid. All fifteen voting judges supported the opinion. There were no concurring or dissenting opinions.

The case arose because the Commissioner exercised his discretion under section 482 to allocate income from Altera International to Altera US by increasing Altera International's cost sharing payments by an amount relating to stock-based compensation. The sole purpose of the Commissioner's adjustments was to bring Altera into compliance with the Final Rule, and the Final Rule was the sole basis for such adjustments.

During the rulemaking process, interested parties submitted written comments to Treasury in which they opposed the requirement that controlled participants in a cost sharing arrangement include amounts attributable to stock-based compensation in the cost pool. Commentators informed Treasury that they knew of no transaction between unrelated parties, including any cost sharing arrangement, service agreement, or other contract, in which one party paid or reimbursed the other party for amounts attributable to stock-based compensation. Commentators also provided evidence in the form of member surveys, searches of the SEC's EDGAR system, arm's-length agreements, accounting procedures pertinent to government contracts, and detailed economic analysis—all of which suggested that unrelated parties would not agree to share amounts attributable to stock-based compensation.

In the preamble to the Final Rule, Treasury did not respond directly to any of the evidence provided by commentators. Instead, Treasury asserted that the "uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA." 68 Fed. Reg. 51171, 51173 (Aug. 26, 2003). The Tax Court responded that "[t]his was a mere assertion; Treasury offered no analysis addressing the extent of the supposed differences or explaining why any differences make the cited transactions irrelevant or

Upcoming Tax Events

- **Key Updates on US & Foreign Tax Planning Issues Related to Equity**

  Webinar
  September 3, 2015

- **Baker & McKenzie / Bloomberg BNA Global Transfer Pricing Conference**

  Shanghai, China
  September 17-18, 2015

  Toronto, Ontario
  October 15-16, 2015

- **Baker & McKenzie / Bloomberg BNA International Tax Conference**

  Toronto, Ontario
  October 14, 2015

- **Doing Business Globally**

  Houston, Texas
  October 14, 20155

  Dallas, Texas
  October 15, 2015

  Toronto, Ontario
  October 16, 2015

  Chicago, Illinois
  October 21, 2015

- **16th Annual International Tax and Trust Training Program**

  Miami, Florida
  October 15-16, 2015

- **SALT Roundtables**

  Dallas, Texas
  September 22, 2015

  Houston, Texas
  September 23, 2015

  Palo Alto, California
  September 29, 2015

  Minneapolis, Minnesota
  December 3, 2015

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unpersuasive." *Altera*, 145 T.C. at 64. Indeed, the files maintained by Treasury at the time that it issued the Final Rule did not contain any unrelated-party cost sharing or other agreement, expert opinion, empirical data, published or unpublished article, paper, survey, or report that supported its belief that unrelated parties engaged in a cost sharing arrangement would agree to share amounts attributable to stock-based compensation. Treasury's position was that it was not required to engage in fact-finding or evidence-gathering procedures in promulgating the Final Rule, and that section 482 allocations are not required to be made by reference to uncontrolled party conduct.

Because Treasury and the IRS intended the Final Rule to have the force of law, the Tax Court held that the Final Rule was a legislative rule subject to the notice-and-comment rulemaking requirements in 5 U.S.C. § 553(b) of the Administrative Procedure Act ("APA"). *Altera*, 145 T.C. at 42-43. The court also concluded that the reasonableness of agency decisionmaking is analyzed under *State Farm* and 5 U.S.C. § 706(2)(A) of the APA. For purposes of determining whether Treasury satisfied its obligations under the APA, the Commissioner argued that *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), provided the appropriate standard of review, and that the court should not review the Final Rule under *State Farm* because, among other reasons, "the Supreme Court has never, and [the Tax Court] has rarely, reviewed Treasury regulations under *State Farm*." The court, however, concluded that "whether *State Farm* or *Chevron* supplies the standard of review is immaterial because *Chevron* step 2 incorporates the reasoned decisionmaking standard of *State Farm*." *Altera*, 145 T.C. at 47-48 (*citing Judulang v. Holder*, 132 S. Ct. 476, 483 n.7 (2011)). Accordingly, the court reviewed the Final Rule under *State Farm* and 5 U.S.C. § 706(2)(A), which requires courts to "hold unlawful and set aside agency action, findings, and conclusions" that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

To engage in reasoned decisionmaking, "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made'." *State Farm*, 463 U.S. at 43 (*quoting Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)). "Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Id*.

Although an agency's violation of any of the *State Farm* standards renders a regulation invalid, the Tax Court invalidated the Final Rule on multiple grounds under *State Farm*. First, the court concluded that the Final Rule lacked a basis in fact because "by failing to engage in any fact finding, Treasury failed to 'examine the relevant data'." *Altera*, 145 T.C. at 56 (*quoting State Farm*, 463 U.S. at 43). Further, Treasury's belief that unrelated parties would share amounts attributable to stock-based compensation in a QCSA was not supported by any of the evidence in the administrative record and "every indication in the record point[ed] the other way." *Id*. at 53 (*quoting State Farm*, 463 U.S. at 57). Second, the court concluded that Treasury failed to articulate a rational connection between the facts found and the choice made. The court was unpersuaded by the Commissioner's argument that the Final Rule was reasonable because it eased administrative burdens because "Treasury failed to give this--or any other--

explanation for treating all QCSAs identically in the preamble to the final rule," and the court could not "reasonably discern that this was Treasury's rationale for adopting a uniform final rule because the administrative benefits of a uniform final rule are entirely speculative." *Id*. at 58 (internal citations omitted). Third, the court stated that Treasury's failure to respond to significant comments "frustrate[d] [its] review of the final rule and was prejudicial to affected entities." *Id*. at 65. Finally, the court concluded that the Final Rule was contrary to all of the evidence before Treasury. *Id*. at 66.

In arriving at its holding, the Tax Court focused primarily on Treasury's disregard of the facts and evidence in the administrative record, and the lack of evidence or information to support its belief that unrelated parties to a QCSA would share amounts attributable to stock-based compensation in every case. "Indeed, Treasury's '*ipse dixit* conclusion, coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decisionmaking'." *Id*. at 69-70 (*quoting Ill. Pub. Telecomms. Ass'n v. FCC*, 117 F.3d 555,564 (D.C. Cir. 1997)). The Tax Court's application of the reasoned decisionmaking standard demonstrates that fundamental administrative law principles affect the analysis of the validity of Treasury Regulations. This approach might be used with respect to other Treasury Regulations as well, including those outside of the transfer pricing area.

A. Duane Webber, Andrew P. Crousore, Phillip J. Taylor, Joseph B. Judkins, Kristyn A. Judkins, Kristen B. Proschold, and Joseph A. Myszka led the Baker & McKenzie team that represented the taxpayer in this case.

By Joseph B. Judkins, Kristyn A. Judkins, and A. Duane Webber, Washington, DC

Crowded Fall Calendar for Congress

Congress will have a full plate this fall when it returns from the August recess. Congress will need to address multiple must-pass bills, including an increase in the government's ability to borrow (aka, the debt limit), spending bills to fund the government, the extension of more than fifty expired tax provisions (extenders), and another extension of the Highway Trust Fund.

Funding the Government

Funding for the federal government expires this September. Congress is unlikely to pass a budget this year, despite the fact that the Republicans control both houses. Rather, Congress is likely to pass a continuing resolution bill that will fund the government through the fiscal year. Congress may further decrease the IRS budget, which may place further pressure on the IRS to make due with less. This could further affect the ability of the IRS to timely issue guidance (e.g., private letter rulings, revenue rulings, and regulations), and the IRS may make changes to programs in light of such cuts. This is an issue worth following, as it may greatly affect the quality of services provided to taxpayers.

Extenders

Like the movie Groundhog Day, the more than 50 tax provisions expired at the end of 2014. The House Committee on Ways and Means (Ways and Means) marked up several bills this year that would permanently extend certain provisions, such as H.R. 636 (America's Small Business Tax Relief Act of 2015), which would permanently increase the benefit of current expensing under Code Section 179 to $500,000 with a higher phase-out where the cost of section 179 property placed into service in the taxable year exceeds $2 million. The House passed the bill on February 13, 2015. The House also passed a permanent research credit (H.R. 880, the American Research and Competitiveness Act of 2015) on May 20, 2015. Ways and Means believes tax reform will be easier if Congress can permanently extend some provisions prior to considering comprehensive tax reform when the next president takes office.

Although the Senate has not taken up efforts to permanently extend these and other provisions, the Senate Committee on Finance (Finance Committee) successfully marked up an extenders bill on July 21, 2015, that would extend the expired provisions through 2016. S. 1946, the Tax Relief Extension Act of 2015, reflects the bipartisan action of the Finance Committee to address extenders before the end of the year. The Senate will need to consider whether it is willing to devote 40 hours to debate this bill and any amendments that could be added, such as the repeal of the Medical Device Excise Tax. If the Senate is able to pass a bill this fall, then the Finance Committee and Ways and Means could conference a bill and pass extenders before the end of the year. If Finance Committee Chairman Hatch is unable to get Senate floor time, then extenders will likely be passed in December as part of an end of year deal, similar to the outcome in 2014.

The Highway Trust Fund Bill – A Path for International Tax Reform?

The Federal government pays for our roads and transportation infrastructure through the Highway Trust Fund (the HTF). The HTF is generally subsidized by the gas tax, but the gas excise tax has not been increased since 1993, and is not indexed for inflation. Congress and the President are looking for a long term solution. The Senate and President would like to pass a long term bill that covers the HTF for at least two more years. However, the House believes a short term patch provides a path to include international tax reform as part of a longer term HTF.

The HTF expired on July 31, 2015, and Congress needed to reach an agreement to prevent a disruption of various transportation projects. The House won, and Congress extended the HTF through October 29, 2015 in H.R. 3236, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. The President signed the bill into law on July 31, 2015, and H.R. 3236 contains more than $4.95 billion in offsets. One of the provisions overturns the holding in *United States v. Home Concrete & Supply LLC*, 132 S.Ct. 1836 (2012), clarifying that an overstatement of basis that results in a greater than 25 percent of the amount of gross income stated in the return extends the statue of limitation period to assess tax from three to six years. H.R. 3236 also requires consistency between estate tax value and income tax basis of assets acquired from a decedent.

But the most important part of H.R. 3236 is the extensions of the HTF through October 29, 2015, which will set up a fall debate on international tax reform. There are three proposals that will be considered: The Bipartisan Framework for International Tax Reform, the Innovation Promotion Act of 2015, and a modified version of the international provisions of the Tax Reform Act of 2014 (H.R. 1). All of these proposals share a common theme – some form of dividend exemption system coupled with benefits for US-based multinational businesses that hold intellectual property in the United States and exploit such property from the United States.

The Bipartisan Framework for International Tax Reform

The Bipartisan Framework for International Tax Reform (the Framework) is the result of the work by Senators Portman (R-OH) and Schumer (D-NY), who were the co-chairs of the International Tax Bipartisan Tax Working Group. The Framework is a high level document that recommends a dividend exemption regime, a patent box regime, anti-base erosion provisions, an interest expense limitation, and a deemed repatriation holiday. The level of dividend exemption is not specified.

There are several key open questions for the patent box, such as what IP is covered and when, what level of activity in the United States is required to benefit from the provision, and how to encourage the onshoring of IP. More important, the Framework does not articulate the rate of tax on such income. The anti-base erosion provision is likely some form of minimum tax that would "dissuade companies from shifting money to tax haven jurisdictions." The term "tax haven jurisdiction" is not defined, but it likely refers to those jurisdictions that impose little or no corporate income tax. Senators Portman and Schumer also stated that they want to attack excessive interest deductions, and they are working on ways to "allow for legitimate intra-group lending while at the same time stopping disproportionate leveraging to avoid US taxation and gaming of interest expense limits in place." Senators Portman and Schumer did not chair the Business Income Tax Bipartisan Tax Working Group at Senate Finance, and as a result, the Framework does not contain recommendations on changes to the corporate tax rate.

The Innovation Promotion Act of 2015

Shortly before the August recess, Congressmen Boustany (R-LA) and Neal (D-MA) released a draft patent box bill, the Innovation Promotion Act of 2015 (the Innovation Act). This draft bill may greatly influence how Ways and Means proceeds on international tax reform.

The Innovation Act would provide for a 10 percent tax rate (a 71 percent deduction) for innovation box profits from qualifying property. Qualifying property is defined as Code Section 936(h)(3)(B)(i) property, section 168(f)(3) property, and computer software as defined in section 197(e)(3)(B). Innovation box profit is the tentative innovation profit times the five-year research and development expense for US research over the five-year total costs of the taxpayer (not including cost of goods sold, interest or taxes). The tentative innovation profit is the gross receipts reduced by cost of goods sold and other expenses properly allocable to such gross receipts. Qualified gross receipts are defined as receipts from the sale, lease, license, or other disposition of qualifying property.

The draft bill also provides that the distribution of qualifying property by a controlled foreign corporation (CFC) to its US parent will not be a taxable event so long it is pursuant to a qualified plan.

Congressmen Boustany and Neal issued a request for feedback, including general technical comments on the draft as well as a list of eight detailed questions, including: (1) Is the scope of qualifying intellectual property appropriate? (2) Are there other costs or expenditures that relate to innovation that should be included in the numerator, and can such costs be defined in a manner that limits potential abuse? (3) How should the deduction for innovation profits be coordinated with the research credit (Code Section 41) and the domestic production deduction (Code Section 199)? (4) Does this legislation help your company remain competitive in the global marketplace, relative to your foreign counterparts? For a complete list of the questions, please visit http://waysandmeans.house.gov/wp-content/uploads/2015/07/2015-07-29-Boustany-Neal-Innovation-Box-Questions.pdf.

Chairman Ryan issued a release in support of the Innovation Act. The justification for the bill include discouraging foreign takeovers of US companies, competing with other countries that have innovation or patent boxes, and to prevent harm from the OECD project on base erosion and profit shifting.

The Tax Reform Act of 2014 (H.R. 1)

Former Ways and Means Chairman Dave Camp's H.R. 1 also contains a dividend exemption system coupled with a reduced rate on intangible income. H.R. 1 contains a carrot and stick approach. A US corporation's foreign market imputed intangible income that is in excess of 10 percent of its depreciable bases would be taxed at 15 percent. Conversely, a CFC that exploits its intangibles abroad would be taxed currently at 15 percent (less foreign tax credits) on its foreign base company intangible income, as determined on a per CFC basis. H.R. 1 also provides for a mandatory repatriation at a bifurcated rate of 8.75 percent for cash or cash like investments and 3.5 percent on all other post-1986 deferred earnings.

While former Chairman Camp retired at the end of the last Congress, Chairman Ryan continues to review the bill and may make modifications to it in this Congress.

Conclusion

It is likely that Congress, especially the House, will have a debate on whether to include international only tax reform as part of the HTF reauthorization. The politics will be very challenging, as international tax reform may not benefit primarily domestic companies and most pass through businesses. The debate will likely not include a discussion of reducing the corporate and individual tax rates in 2015. Additionally, the Joint Committee on Taxation revenue estimates may constrain what is possible. It is also unclear if the business community supports the Innovation Act or the Bipartisan Framework without a corporate income tax rate reduction. Finally, and perhaps the greatest impediment, it is unclear if Senate leadership supports international only tax reform as part of the HTF bill.

Considering the truncated time for input and debate, businesses that wish to make technical comments and respond to the questions in the Innovation Act should do so, probably before Labor Day.

By Joshua D. Odintz, Washington, DC

IRS Issues Long-Awaited Revenue Procedures Providing Guidance for Mutual Agreement Requests and APA Submissions

On August 12, the IRS issued revenue procedures that update and modify the procedures for taxpayers seeking relief from double taxation under US tax treaties through the Mutual Agreement Procedure (MAP), as well as taxpayers seeking Advance Pricing Agreements (APAs) for their crossborder intercompany transactions. (Rev. Proc. 2015-40 (MAP) and Rev Proc 2015-41 (APA)). In late 2013, the IRS had issued notices (Notice 2013-78 (MAP) and Notice 2013-79 (APA)) proposing significant revisions to the existing revenue procedures, which had been most recently issued in 2006. (Rev. Proc. 2006-54 (MAP) and Rev. Proc. 2006-9 (APA)). According to David Varley, acting Director of Transfer Pricing Operations with the IRS's Large Business & International division (LB&I), the new revenue procedures reflect ongoing work under the Organization for Economic Cooperation and Development's ("OECD") project on base erosion and profit shifting (BEPS), and in particular BEPS Action 14, which relates to improvements in dispute resolution, as well as work of the OECD's Forum on Tax Administration to improve resolution of double tax cases.

In addition to new guidance on "interrelated" issues and transactions, increased user fees and statute of limitations extensions, the APA revenue procedure includes a modification to the standard APA filing deadline, which generally continues to be the US tax return filing date for the first APA year. The modification is for bilateral APAs with earlier filing deadlines in the other treaty country. In those cases, the US APA request must be filed within 60 days after the request is filed in such other country, a period that can be extended by 120 days if the taxpayer pays the user fee (a "dollar file") within the initial 60-day period. Rev. Proc. 2006-9 also included a dollar file option, but see below for the transition rule.

Each revenue procedure includes an appendix setting forth a comprehensive and detailed list of items that a taxpayer must provide to the IRS when requesting either double tax relief or an APA. According to Varley, the procedures are intended to improve the practical operations of the Advance Pricing and Mutual Agreement Office that manages both processes, and to enhance taxpayers' access to both MAP and APAs, an understandable impulse given the anticipated increase in double tax controversies following the BEPS project.

The new MAP revenue procedure has an effective date of October 30, 2015, (with an effective date of August 31, 2015 for the specific changes to discretionary LOB determinations included in Section 3.06(2)) and the new APA revenue procedure has an effective date of December 29, 2015. Taxpayers may file requests under either the existing or the new procedures during the transition periods, although it should be noted that the dollar file option of Rev. Proc. 2006-9 is not effective for user fees paid after August 31, 2015. We are preparing a detailed analysis of both revenue procedures, which will be published in the coming weeks.

By Barbara J. Mantegani, Washington, DC and
Elizabeth A. Yablonicky, Chicago

The DC Circuit Rejects the IRS's Attempt to Tax a Wholly Foreign Transaction

A rule of statutory construction that was little-known in the tax world made a big entrance into US tax law this summer. In *Validus Reinsurance v. Commissioner*, 786 F.3d 1039 (D.C. Cir. 2015), the DC Circuit held that there is a presumption that US tax statutes do not apply extraterritorially absent clear instruction from Congress.

While the "presumption against extraterritoriality" should not have an effect on most US income tax statutes (since income taxes are imposed only on US persons or foreign persons with a trade or business in the United States), the presumption raises questions about the extraterritorial application of other parts of the Internal Revenue Code—most notably Chapter 3 withholding obligations—on purely foreign transactions.

Overview of the Presumption Against Extraterritoriality

The presumption against extraterritoriality has often been applied by the Supreme Court outside the tax context and reflects the "longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to only apply within the territorial jurisdiction of the United States." *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991). The presumption provides that a statute does not apply extraterritorially unless Congress "clearly expresses" its "affirmative intention" to give the statute extraterritorial effect. *Morrison v. Nat'l Austrl. Bank Ltd.*, 561 U.S. 247, 255 (2010).

Validus represents the first time a court has applied the presumption to a US tax statute. In addition, it gives taxpayers a framework to determine when a tax statute has extraterritorial effect and demonstrates that it can be challenging for the government to successfully rebut the presumption that Congress did not intend for a statute to apply extraterritorially.

Application in *Validus*

The tax statute at issue in *Validus* generally imposes a one-percent tax on "reinsurance contracts" issued by foreign insurers who are not engaged in a US trade or business. *See* Section 4371(3). A reinsurance contract arises when an insurance company, which has already directly issued an insurance policy to a policyholder, purchases insurance from another insurer to protect itself in the event that it has to pay claims to the policyholder. Thus, a reinsurance contract is effectively insurance for insurers. Moreover, by entering into a "retrocession contract" with another reinsurer, the issuer of a reinsurance contract can purchase insurance on the reinsurance contract that it previously issued to the original insurance company. The issuing and reinsuring of retrocession contracts can continue into perpetuity.

In *Validus*, the government argued that it could impose the one-percent reinsurance excise tax on both reinsurance and retrocession contracts. The DC Circuit did not dispute that the IRS had the authority to tax a reinsurance contract between a US insurance company and a foreign reinsurer. But the court held that the IRS overreached when it attempted to tax the retrocession contract between the two foreign reinsurers. The court reasoned that "[t]he wholly foreign retrocessions at issue are materially different from the reinsurance contracts in which there is privity of contract between the foreign reinsurer and a domestic (US) individual or entity, or entity doing business in the United States." The court also noted that by permitting the IRS to impose the tax extraterritorially, the IRS could impose cascading taxes on the creation of each new retrocession contract. Accordingly, the court's holding in *Validus* establishes that, even though a tax statute explicitly refers to foreign corporations, the presumption against extraterritoriality can still prevent the statute from applying to a foreign transaction unless Congress clearly intended the statute to apply to the foreign transaction that the IRS is attempting to tax.

After determining that the insurance excise tax had an extraterritorial effect when applied to retrocession contracts between foreign insurers, the DC Circuit examined whether Congress clearly expressed its affirmative intent for the tax to apply in such contexts. Legislative history did not clearly and affirmatively indicate that Congress intended for the tax to apply extraterritorially, so the court refused to apply the reinsurance tax to foreign-to-foreign retrocession contracts—even though the court acknowledged that the government presented a strong policy reason as to why the tax should apply extraterritorially. The government also sought deference for Treasury's interpretation of the excise tax under *Chevron U.S.A. Inc. v. Natural Resources Defense Fund*, 467 U.S. 837 (1984). But the court rejected that request, primarily because the government could not show that Treasury had considered the effect of the presumption against extraterritoriality in its published guidance regarding the excise tax. Notably, the court also suggested that *Chevron* deference may not apply to an agency's conclusion that a statute has extraterritorial effect unless there is evidence that Congress clearly intended it to have such effect. In doing so, the DC Circuit cited last year's Second Circuit opinion, *Liu Meng-Lin v. Siemens AG*, 763 F.3d 175, 182 (2d Cir. 2014), which expressed similar doubts about the appropriateness of *Chevron* deference in the face of the "strong presumption" against extraterritoriality. Thus, *Validus* demonstrates how difficult it can be for the government to establish that Congress intended a statute to apply extraterritorially.

Open Questions About the Presumption Against Extraterritoriality

The *Validus* analysis raises questions about the IRS's ability to enforce Chapter 3 withholding requirements in purely foreign transactions between foreign entities, including royalty payments between related foreign parties that are members of a corporate group that includes one or more US companies. The pertinent statutory withholding scheme includes Code Section 881(a), which imposes a 30-percent tax on "the amount received from sources within the United States by a foreign corporation" for certain income categories, and Code Section 1442, which provides for withholding of that tax at the source. Royalties are included under the statutory scheme.

The Tax Court has not applied the presumption against extraterritoriality to withholding cases, but similar to the result in *Validus*, the Tax Court has refused to apply the Code's withholding obligations to a foreign transaction that could have resulted in cascading royalties. In *SDI Netherlands v. Commissioner*, 107 T.C. 161 (1996), the taxpayer was a Netherlands corporation that paid royalties to a Bermuda corporation under a license for the use of certain software. The taxpayer sublicensed the software to a related US company and received royalties under the sublicense. The Commissioner determined a deficiency based on the foreign taxpayer's failure to withhold royalty payments under that sublicense. The taxpayer in *SDI Netherlands* contended that its royalty payments to the Bermuda corporation were not "received from sources within the United States" because the payments were made by a foreign corporation to another foreign corporation. The Tax Court concluded that although the Netherlands company received some royalty payments from the US company under the sublicense, the subsequent payments that the Netherlands company made to the Bermuda company under the license were part of a separate license agreement. Because the license and the sublicense were separate and distinct from each other, the Tax Court concluded that the royalties that the Netherlands company paid to the Bermuda company did not retain their US-source character. Although the court in *SDI Netherlands* did not mention the presumption against extraterritoriality and instead rested its holding largely on the terms of the pertinent US-Netherlands tax treaty, that rule of statutory construction would have provided additional support for the Tax Court's conclusion.

The presumption against extraterritoriality might also apply in other cases in which withholding is an issue. For example, if a foreign company has unclear US withholding obligations for royalties or derivative payments, the presumption against extraterritoriality may help to demonstrate that foreign transactions between foreign entities may not be subject to US withholding obligations even though the transactions give rise to US-source income. Similarly, the presumption against extraterritoriality may also be relevant to other excise taxes as well as IRS attempts to request foreign documents. In sum, the presumption against extraterritoriality could have significant impact on the analysis of the IRS's ability to apply US tax laws abroad.

By Joseph B. Judkins, Washington, DC
and John D. Barlow, Washington, DC

IRS Issues Temporary Regulations Under Code Section 337(d)

In 1992, New Kids on the Block were performing in arenas across the US, the Batmobile was racing across movie screens, a Clinton was campaigning for the White House and the Treasury Department issued Proposed Regulations under Code Section 337(d) (commonly referred to as the "May Company Regulations" named after a transaction involving May Department Stores). Fast forward twenty-three years to 2015 and not much has changed. New Kids on the Block is still hanging tough, Batman is back in Gotham, a Clinton is running for the White House and the Treasury Department issued Temporary Regulations under section 337(d).

On June 12, 2015, the Treasury Department and IRS issued temporary regulations under section 337(d) designated as Treas. Reg. § 1.337(d)-3T (the "Temporary Regulations") that prevent a corporate partner from avoiding corporate-level gain through transactions with a partnership involving equity interests of the partner. The Temporary Regulations update and modify the May Company Regulations issued in 1992, and apply to transactions occurring on or after June 12, 2015.

Section 337(d) provides that the Treasury Department will prescribe regulations to carry out the purpose of the repeal of the *General Utilities* doctrine. After the repeal of the *General Utilities* doctrine, the IRS became concerned that corporate taxpayers were avoiding Code Section 311(b) by contributing appreciated property to a partnership and receiving their own stock, which was contributed to the partnership by another partner or purchased by the partnership, in exchange upon the partnership's liquidation. Code Section 1032 and the provisions of subchapter K could allow the corporate partner to dispose of appreciated property without paying tax. The May Company Regulations were issued to target these types of transactions and set forth two rules, the "deemed redemption rule" and the "distribution rule," in an attempt to prevent the avoidance of section 311(b). Under the deemed redemption rule, a partner recognized gain on a transaction that had the economic effect of an exchange by a partner of its interest in appreciated property for an interest in stock of the partner owned by the partnership. The distribution rule treated the distribution by a partnership to a partner of the partner's stock as a redemption or exchange of the partner's stock for a portion of the partner's partnership interest equal in value to the stock distributed.

The Temporary Regulations generally retain the deemed redemption rule set forth in the May Company Regulations. The Temporary Regulations apply to a transaction or a series of transactions that have the effect of an exchange by a corporate partner of its interest in appreciated property for an interest in the stock of the corporate partner that is owned, acquired or distributed by the partnership (a "Section 337(d) Transaction"). Under the new regulations, a Section 337(d) Transaction may occur if: (1) a corporate partner contributes appreciated property to a partnership that owns stock of the corporate partner; (2) a partnership acquires stock of the corporate partner; (3) a partnership that owns stock of the corporate partner distributes appreciated property to a partner other than the corporate partner; (4) a partnership distributes stock of the corporate partner to the corporate partner; or (5) a partnership agreement is amended in a manner that increases a corporate partner's interest in the stock of the corporate partner. If a partnership engages in a Section 337(d) Transaction, the corporate partner must recognize gain.

The Temporary Regulations set forth general principles that apply in determining the amount of appreciated property effectively exchanged for stock of the corporate partner. Under these rules, a corporate partner that is engaged in a Section 337(d) Transaction must recognize gain at the time, and to the extent, that the corporate partner's interest in appreciated property is reduced in exchange for an increased interest in "stock of the corporate partner." Stock of the corporate partner includes stock of a corporate partner that is engaged in the Section 337(d) Transaction as well as stock of a corporation that controls, within the meaning of Code Section 304(c), such corporate partner.

The Temporary Regulations were amended on July 2, 2015 to clarify that in applying the control test in section 304(c), upward attribution under Code Section 318(a)(2)(C) should be used but downward attribution under section 318(a)(3)(C) should not be used. The clarification addresses the concern that downward attribution could be used sweep in stock of lower-tier corporations, which was not the intent as expressed in the preamble of the Temporary Regulations.

There are two rules that impact the basis of the corporate partner and the partnership when gain is recognized on a deemed redemption. The inside tax basis of the appreciated property deemed exchanged for the partner stock is increased by the amount of the gain recognized on the deemed redemption, and the corporate partner's basis in its partnership interest is increased by the same amount.

The Temporary Regulations do not adopt the distribution rule as set forth in the May Company Regulations. Instead, the new regulations extend the deemed redemption rule to cover situations in which a distribution of corporate partner stock has previously been the subject of a Section 337(d) Transaction or becomes the subject of a Section 337(d) Transaction as a result of the distribution. In these instances, in addition to any gain recognized under the deemed redemption rule upon the distribution of stock of the corporate partner, the Temporary Regulations also require the corporate partner to recognize gain to the extent that the partnership's basis in the distributed stock of the corporate partner exceeds the corporate partner's basis in its partnership interest immediately before the distribution. However, this additional gain recognition rule does not apply if the gain recognition or basis reduction rules of Code Section 732(f) apply to the distribution.

There are inadvertence and de minimis exceptions in the Temporary Regulations which generally mirror the exceptions set forth in the May Company Regulations. Subject to an anti-abuse rule, the inadvertence exception applies if stock of the corporate partner is disposed of, other than by distribution to the corporate partner or a corporation possessing section 304(c) control of the corporate partner, within a specified period. The de minimis exception can apply if the corporate partner and related persons own in the aggregate less than five percent of the partnership and the value of stock of the corporate partner and the partnership's ownership percentage in the stock of the corporate partner are below certain thresholds. The Temporary Regulations also apply to tiered partnership structures.

Overall, the Temporary Regulations, which were 23 years in the making, incorporate many of the concepts in the May Company Regulations but are clearer and more objective in application.

By Jonathan A. Stevens, New York and W. Justin Hill, New York

The Continued Application of the Supreme Court's Decision in *Woods*

Logan Trust (Tigers Eye Trading, LLC) v. Comm'r

On June 26, 2015, the US Court of Appeals for the District of Columbia in *Logan Trust (Tigers Eye Trading, LLC) v. Comm'r*, 115 AFTR 2d 2281 (D.C. Cir. 2015), addressed the question of whether and when the Tax Court may apply a penalty to a taxpayer who underpays tax by participating in a partnership determined to be a tax shelter. In that case, the taxpayer's partnership, Tigers Eye Trading, was determined to have functioned as a Son of BOSS tax shelter and thus was found to be a sham entity that lacked economic substance. If the Tax Court were permitted to apply the penalty to the partner and make the required corresponding adjustments to the partner's tax return at the partnership level proceeding, then the partner would be required to pay the penalty before it could raise any objections to the application of the penalty based on the partner's unique facts.

The Court determined that the decision of the Supreme Court in *United States v. Woods*, 134 S. Ct. 557 (2013), which was decided after the appeal was first taken in this case, was determinative. For a further discussion of *United States v. Woods* see prior *Tax News and Developments* article, *After Woods, the*

Valuation Misstatement Penalty May Be Applicable to More Transactions (Vol. XIV, Issue 1, February 2014). Applying *Woods*, the Court explained that "in the course of adjudicating matters related to the partnership, the court can announce that any member of the tax-shelter partnership who the IRS later finds shirked his taxes by claiming a basis greater than zero is subject to a gross valuation-misstatement penalty, a penalty that the IRS can impose directly on the partner, requiring him to pay it before bringing a refund action." (internal citations omitted). Nevertheless, as the Court further explained, "*Woods* also made clear that outside basis is not a partnership item that a court has jurisdiction to adjust when reviewing matters involving only the partnership." Rather, that adjustment must be made in proceedings conducted at the partner level, but in making such an adjustment, the court is not required to shut its eyes to the legal impossibility of any partner's possessing an outside basis greater than zero in a partnership that does not exist for tax purposes.

Accordingly, the Court concluded that "although a court may announce that a penalty has been triggered in a proceeding involving the partnership based on the presumption that outside basis in a sham partnership is zero, the court cannot formally adjust a partner's outside basis at that time." Thus, the Court upheld the Tax Court's determination that the gross valuation-misstatement penalty applied to the Tiger's Eye Trading partners and reversed the Tax Court's holding that the Tiger's Eye Trading partners had no outside basis in the partnership.

By Joy Allison Williamson, Dallas

Proposed Regs on PTPs in the Minerals and Natural Resources Industry may have Significant Impact on Investor Returns

On May 6, 2015, the Treasury Department published proposed regulations addressing the application of Code section 7704(d)(1)(E) to publicly traded partnerships ("PTPs") operating in the minerals and natural resources industry. Section 7704(d)(1)(E) identifies certain activities within the minerals and natural resources industry that are considered to generate qualifying income. Earning qualifying income is extremely important to PTPs and their investors. Without sufficient amounts of qualifying income, a PTP will be treated a corporation, rather than a partnership, for US federal tax purposes. Income earned by a PTP characterized as a partnership is only taxed once, as though its owners earned that income directly. In contrast, income earned by a PTP characterized as a corporation is taxed twice–once at the corporate level and again when distributed to its owners. This distinction can have a significant impact on investor returns.

In recent years, the IRS has seen a significant increase in ruling requests, particularly with respect to businesses supporting exploration, development, mining, production, processing, refining, transportation, and marketing activities within the minerals and natural resources industry. In hopes of providing greater certainty in characterizing qualifying income, the proposed regulations (i) clarify and expound upon the list of qualifying activities in section 7704(d)(1)(E), namely, exploration, development, mining, production, processing or refining, transportation, and marketing activities and (ii) detail three requirements that must be met for supporting activities to be considered intrinsic to the qualifying activities (thereby also considered to generate qualifying income).

The standout among these activities is processing or refining. Generally, processing or refining activities include purifying, separating, or eliminating impurities from the mineral or natural resource. However, the proposed regulations go to great lengths to provide industry/resource specific rules because "processing and refining activities vary with respect to different minerals or natural resources." One of the more concerning rules applies to olefins (generally, olefins are by-products of refining hydrocarbons and are primarily used in the production of plastics). The proposed regulations provide that income related to olefins (e.g., ethylene) produced in connection with a petroleum refinery is qualifying income, while income related to olefins produced from natural gas is not. *See* Prop. Reg. § 1.7704-4(e), *Examples 1 and 2*.

The disparate treatment of olefins produced from petroleum as opposed to natural gas appears to be in direct conflict with private letter rulings ("PLRs") issued by the IRS to active PTPs (see comments on the proposed regulations by Boardwalk Pipeline Partners LP and Westlake Chemical Partners LP). If the proposed regulations are finalized in their current form, PTPs relying on PLRs issued to them by the IRS, and PTPs that have been operating under a reasonable interpretation of section 7704, have a 10 year transition period, beginning with the promulgation of the final regulations, wherein they may continue to treat income as qualifying income even if that income is not qualifying income under the final regulations. After the 10 year transition period, only income that meets the requirements of the final regulations will be qualifying income regardless of any rulings made by the IRS to a particular PTP in a prior PLR. If these proposed regulations are finalized, some PTPs may be forced to abandon their partnership structure altogether or divest businesses that, until recently, appeared to be safely within the qualifying activity category. Given such a drastic change, the proposed regulations are likely to have a negative impact for some PTPs possibly including a drop in share prices for the publicly traded interests.

By Matthew S. Mauney, Houston

Options as Listed Transaction and Transactions of Interest

On July 8, 2015, the IRS issued two notices identifying a new listed transaction and a new transaction of interest. In Notice 2015-47, the IRS identified certain types of basket option contracts as a listed transaction. In Notice 2015-48, the IRS identified other basket options transactions as a transaction of interest. Both sets of transactions are reportable for taxpayers. The listed transaction applies to taxpayers who had the transactions in place on or after January 2, 2011. The transaction of interest applies to taxpayers who had transactions in place on or after November 6, 2006. Taxpayers must report the transactions for past years if the relevant statute of limitations was open on July 8, 2015.

In both sets of transactions, taxpayers use options on other financial investments so that the short-term gains and ordinary income of the other investments become long-term capital gain on the disposition of the option. In each case, the participants in the transactions are the investor in the basket option, the general partner of a partnership that purchases the option, or the managing member of a LLC purchasing the option. In addition, the counterparty to the option is a participant in the transaction and must report it to the IRS. If the transaction meets the requirements of both Notices, the transaction is a listed transaction and should be reported as such.

The example of the transaction in both notices has an investor entering into an option contract with a bank. The investor pays a percentage of the value of the underlying financial assets as a premium on the option. The bank invests in the underlying financial assets as a hedge against the option contract. The value of the option is determined by the increases and decreases in value of the underlying financial assets. The investor or its designee has the right to request changes in the composition of the underlying financial assets covered by the option. If the change in the underlying property is made outside the control of the option holder (or designee), then the change in property is not treated as a right to change the underlying financial assets. The notices give an example of a stock split or merger as not being a change controlled by the option holder.

The requirements for the listed transaction under Notice 2015-47 include (a) the contract labeled as an option, (b) the underlying property to the option is primarily marketable securities under § 1.1092(d)-1(a), (c) the option purchaser (or designee) has control over the assets underlying the option or the trading strategy relating to the underlying marketable securities, and (d) the option holder (or designee) or the trading strategy causes a change in the marketable securities underlying the option. The primary distinction between the listed transaction under Notice 2015-47 and the transaction of interest under Notice 2015-48 is the fourth requirement, above, whether or not there has been a change in the underlying marketable securities. If the fourth requirement is not met, the transaction is a transaction of interest, not a listed transaction. If the underlying property is an interest in an actively managed investment fund, such as a hedge fund, the Notices treat the manager of the fund as the designee of the option holder and impute the changes in the underlying fund assets as being controlled by the option holder's designee.

Notice 2015-47 offers a number of arguments that the IRS may pursue against the option holder. The result of the arguments is to deny the long-term capital gain treatment on the entire option and match the timing and character of the income from the underlying financial investments. For example, the IRS argues the option may result in actual ownership of the underlying financial assets by the option holder. Alternatively, the option may be treated as separate contracts on each underlying financial asset that creates a Code Section 1001 event on change in the underlying financial assets. The notice asserts other arguments both listed and unlisted for denying the long-term gain treatment.

Taxpayers who participated in a transaction covered by either Notice 2015-47 or Notice 2015-48 have a reporting obligation that may be due as soon as 90 days after the publication of the notices. The notices extend some of the reporting requirements to 120 days after publication of the notices. The filing must be made with the Office of Tax Shelter Analysis. Taxpayers also face potential penalties under Code Section 6707A (for failure to disclose), section 6662 (substantial understatement of tax), and section 6662A (understatement related to reportable transactions). Also, failure to disclose may affect the taxpayers statute of limitations under section 6501(c)(10) until a proper disclosure is made. The notices also place reporting and record keeping requirements on certain material advisors to taxpayers engaged in the described transactions.

By Robert S. Walton, Chicago

World Customs Organization Releases Guide to Customs and Transfer Pricing

As multinational enterprises (MNEs) continue to expand globally and establish and expand their vertically integrated operations, their supply chains often require raw materials, partially-finished inventory and finished goods to cross borders, sometimes multiple times, before being sold outside of the global group. These related-party cross-border transactions expose companies to scrutiny by both customs and tax authorities. When the exporter and importer are related, customs officials must determine if the transaction value may be accepted, that is, that the relationship did not influence the price paid in the related-party transaction. Tax authorities in nearly all countries that have transfer pricing laws review the results of related party transactions under the "arm's length standard," which provides that the terms of commercial and financial dealings between associated enterprises must not differ from the terms that would be agreed to between independent enterprises. Although the two standards are stated somewhat differently, the underlying question facing both customs and tax authorities is broadly the same, that is, did the relationship between the entities allow the MNE to achieve a different result, from either a customs or tax standpoint, than it would have achieved if the relationship was not present?

WCO Releases Guide to Customs and Transfer Pricing

On June 24, 2015, the World Customs Organization (WCO), an independent intergovernmental body whose mission is to enhance the effectiveness and efficiency of customs administrations, released its Guide to Customs Valuation and Transfer Pricing ("the Guide"). For many years both customs officials and tax authorities have encountered challenges with auditing transactions involving the importation of goods that are sold by one related party to another related party. In its Introduction, the WCO explains that the Guide is intended to assist customs officials who are responsible for customs valuation policy or who conduct audits of MNEs, and to provide information to MNEs, their advisors, and tax administrations that deal with transfer pricing.

The Guide reviews the landscape of customs and transfer pricing, including:

- presenting the background to the generally accepted customs valuation methodologies;
- providing a summary of basic transfer pricing principles;
- identifying the linkages between transfer pricing and customs valuation;
- presenting situations where transfer pricing information might be used when conducting a customs audit of related party transactions;
- suggesting some good practices for customs valuation policy managers, businesses that have related party import transactions, and tax administrations that have responsibility for transfer pricing issues; and
- highlighting the ways that transfer pricing documentation prepared for tax purposes can also provide information relevant to a customs examination.

To the extent that companies are managing the movement of goods through their supply chains through captive logistics operations, coordinating the customs and tax issues internally can provide a significant benefit, both by potentially reducing some upfront compliance costs of documentation and mitigating the risk of being whipsawed by customs and tax officials with divergent audit incentives. The Guide provides valuable, relevant information for companies seeking to manage efficiently their tax and customs matters, and includes the International Chamber of Commerce ("ICC") Policy Statement on Transfer Pricing and Customs. The Guide is available online at http://www.wcoomd.org/en/topics/key-issues/revenue-package/~/media/36DE1A4DC54B47109514FFCD0AAE6B0A.ashx.

By Barbara Mantegani, Washington, DC

The IRS Clarifies the Application of Notice 88-108 in CCA 201516064

Notice 88-108, 1988-2 CB 445 (the "Notice"), provides an exception to Code Section 956 for certain short-term obligations of related US persons that a CFC holds. Under the Notice, an obligation of a related US person that a CFC holds at quarter-end is not United States property for purposes of section 956, provided that: (i) the obligation is collected within 30 days of being issued, and (ii) the CFC holds obligations of related US persons for fewer than 60 days during the taxable year. In April of this year, the IRS released Chief Counsel Advice 201516064 (Dec. 22, 2014) (the "CCA"), which clarifies that the Notice applies only to the extent that a CFC holds all obligations of related US persons for fewer than 60 calendar days during a taxable year in the aggregate. The CCA effectively eliminates the argument that the 60-day rule applies only to obligations that would otherwise have qualified for the short-term obligation exception in the Notice, but for the fact that the CFC holds such obligations for 60 days or more during a taxable year. Accordingly, under the CCA, if a CFC loans $1 billion to its US parent for a 25-day period that crosses the CFC's quarter-end and also loans the parent $10 million for a 40-day period that does not cross the CFC's quarter-end, the Notice does not apply because the CFC holds obligations of its parent for 60 days or more. As a result, the US parent has a potential $250 million section 956 inclusion.

While the CCA confirms what many practitioners and taxpayers already suspected the IRS's position to be, for those taxpayers that rely on the Notice, the CCA highlights the importance of having in place internal accounting systems that can identify all potential obligations of a group's US affiliates that are held by CFCs, as the Notice presents numerous traps for unwary taxpayers. For example, a CFC that sells goods or provides services to its US parent arguably accrues a receivable from - i.e., an obligation of - the parent. If the CFC does not invoice the parent, this obligation could potentially be outstanding for months or years, tainting obligations that the group otherwise believes qualify for the short-term obligation exception in the Notice. Similarly, if a CFC provides its US parent with a 10-day loan of $100,000,500 over the CFC's quarter-end, but an administrative glitch results in the US parent transferring back only $100,000,000 to the CFC at the end of the 10-day period, the remaining $500 could taint the entire loan and give rise to a potential section 956 inclusion of roughly $25 million.

Stewart R. Lipeles (Palo Alto), John D. McDonald (Chicago), and Ethan S. Kroll (Palo Alto) discuss the CCA, the Notice, and the issues above in greater detail in *Beware the Needle in the Haystack: The IRS Clarifies the Application of Notice 88-108 in CCA 201516064*, which appeared in the July 2015 issue of *Taxes: The Tax Magazine* and also is available under publications at www.bakermckenzie.com.

The STARS Continue to Revolve – The First Appellate Decision

One of the more interesting tax developments over the last few years have been the STARS cases, which considered the tax consequences of a structured transaction that resulted in foreign tax credits being claimed by US financial institutions in connection with large loans. The transactions have resulted in "split decisions," with one court calling the transaction "reprehensible" while another granted summary judgment to the taxpayer.

As could be anticipated, these cases are now winding their way to the appellate courts. In the first reported appellate decision concerning a STARS transaction, *Salem Financial, Inc.*, 786 F.3d 932 (C.A. F.C. 2015), the Federal Circuit affirmed in part the Court of Federal Claims' decision that the foreign tax credits had to be disallowed under the economic substance doctrine, and further upheld penalties imposed on the taxpayer. However, the appellate court specifically rejected the proposed disallowance of interest deductions, which meant that the taxpayer still received a substantial amount of tax benefits from the STARS transaction.

A full analysis of the *Salem* decision is available in the August issue of *The Journal of Taxation,* "The STARS Continue to Revolve - The First Appellate Decision" by Richard M. Lipton. An electronic version will be available in early September.

US Tax Court Issues Important Decision on Investor Control Over Variable Life Insurance Policy Assets

On June 30, 2015, the US Tax Court issued *Webber v. Commissioner*, 144 T.C. no. 17, an important decision applying the "investor control" doctrine to two non-US private placement life insurance ("PPLI") policies. Although the Tax Court decided the case on extreme facts raised in the case, the decision highlights the significance of the investor control doctrine in insurance planning for high net worth individuals and indicates that the investor control doctrine is an area of scrutiny by the IRS. As illustrated by the court's decision in *Webber*, policyholders, insurers, and investment managers should each critically examine both the governing contractual language and their course of conduct when administering insurance policies and investing assets backing policies.

For a full discussion on *Webber*, please see previously released Global Tax Client Alert *US Tax Court Issues Important Decision on Investor Control Over Variable Life Insurance Policy Assets*, distributed on July 2, 2015 and available under publications at www.bakermckenzie.com.

New York State Finds Group is Unitary, Permits Combined Reporting

The New York State Tax Appeals Tribunal ("Tribunal") determined that SunGard Data Systems, Inc. and SunGard Capital Corp. (collectively "SunGard") properly filed an amended return on a combined basis with their subsidiaries (collectively, the "SunGard Group") for New York corporation franchise tax purposes for the 2005 and 2006 tax periods ("Periods at Issue"). *See SunGard Capital Corp. and Subsidiaries*, New York, Tax Appeals Tribunal, Decision DTA Nos. 823631, 823632, 823680, 824167 and 824256 (May 19, 2015). Specifically, the Tribunal concluded that the SunGard Group was engaged in a unitary business with several of its subsidiaries, and that filing on a separate return basis resulted in distortion for the Periods at Issue. Besides being a good win for taxpayers, this case is important because the New York State Department of Taxation and Finance ("Department") has historically attempted to "de-combine" holding companies in a loss position from the rest of the combined group, resulting in an increase in the combined group's franchise tax liability. In this case, however, the Tribunal found that SunGard properly filed its amended returns on a combined basis and that SunGard was included in the SunGard Group.

The SunGard Group included dozens of legal entities, most of which were directly or indirectly involved with providing information technology services. The companies provided numerous services for one another and centralized systems, including a cash management system and a systems management system (e.g., networks, computer infrastructure, etc.). Additionally, SunGard, the parent holding company, incurred approximately $131 million in costs for providing centralized corporate-level functions and services on behalf of all entities and business segments with the SunGard Group. For example, SunGard helped manage the group's budget, insurance, accounting, tax, and legal matters, among other services. SunGard offered these functions and services across the group in order to achieve efficiencies of scale, but in most cases, it was not compensated for these services by the other group members.

During the Periods at Issue, New York permitted combined filing if taxpayers could demonstrate that: (1) the parent company owned at least 80% of the capital stock of the relevant subsidiaries; (2) the businesses were unitary; and (3) distortion resulted from filing on a separate basis. On the third prong, there was a presumption of distortion if there were "substantial intercorporate transactions" between related members (i.e., greater than or equal to 50% of group's total transactions); however, this presumption was rebuttable through a showing of arm's-length transactions.

The Department argued that the SunGard Group was not unitary and that the intercompany transactions did not result in distortion. Neither party disputed that SunGard owned at least 80% of the capital stock of all the relevant entities during the Periods at Issue, or that there were not "substantial intercorporate transactions" between SunGard Group members during the Periods at Issue. As such, SunGard had to demonstrate that the entities in the proposed combination were unitary and that distortion would result if the members filed on a separate return basis. In reversing the Administrative Law Judge, the Tribunal found that SunGard Group satisfied both of these requirements and was permitted to file on a combined basis.

Unitary Business Analysis

The Tribunal applied the federal unitary doctrine and New York's regulations to shape the contours of its analysis in determining that the SunGard Group was engaged in a unitary business. The US Supreme Court has previously addressed this highly factual issue, stating that the “prerequisite to a constitutionally acceptable finding of unitary business is a flow of value.” *Container Corp. of Am. v. Franchise Tax Bd*., 463 U.S. 159, 178 (1983). And the “hallmarks” of a unitary relationship among businesses are “functional integration, centralized management and economies of scale.” *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, 553 US 16, 30 (2008). These hallmarks may be shown by “transactions not undertaken at arm’s length; a management role by the parent which is grounded in its own operational expertise and operational strategy; and the fact that the corporations are engaged in the same line of business.” *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 US 768, 789 (1992). Additionally, New York published regulations on what constitutes a unitary business, and these regulations are generally consistent with the federal unitary doctrine (e.g., related activities, same line of business, etc.). *See* 20 NYCRR former 6-2.2[b] renumbered 20 NYCRR 6-2.3[e] effective. Jan. 2, 2013.

The Tribunal held that the SunGard Group satisfied each of the unitary indicia from *Allied-Signal*, as well as the unitary requirements set forth in New York's regulations. In determining that a unitary business existed, the Tribunal noted, in part, that: (1) the members of the SunGard Group operated in the same line of business; (2) the customers were similar among group members; (3) the parent companies of the SunGard Group played a managerial role in the group, providing operational expertise and strategy; (4) the SunGard Group participated in internal transactions that were not at arm's length; (5) the flow of value within the SunGard Group through the use of a cash management system that allocated funds from one member of the group to another as needed; and (6) the fact that SunGard was responsible for the group's purchasing, marketing, and technology services. While it was noted that product and services differed between certain business segments within the SunGard Group, the Tribunal opined that the group, as a whole, was primarily engaged in selling software and processing services, and that the different segments complemented each other.

Taken as a whole, the Tribunal reasoned, the outlined factors resulted in a finding that the SunGard Group was unitary for purposes of filing on a combined basis for franchise tax purposes for the Periods at Issue.

Distortion Analysis

The Tribunal was satisfied with the SunGard Group's showing that there was sufficient distortion to permit combined reporting. New York regulations provided that the distortion requirement was satisfied if “the filing of a report on a separate basis . . . results in a distortion of such taxpayer’s activities, business, income or capital...” 20 former NYCRR 6-2.3(d). The concept of distortion is related to the unitary analysis; however, for a showing of distortion, the taxpayer must “identify with particularity the activities or transactions which [they claim] give rise to distortion and explain how distortion arises from those activities or transactions.” *Matter of Silver King Broadcasting of N.J.*, Tax Appeals Tribunal (May 9, 1996).

The Tribunal was moved, in part, by the parent company's uncompensated responsibilities for the SunGard Group in the areas of budget, debt management, banks and bondholders, all central office functions, purchasing, marketing, and technology. By not charging for such services, the Tribunal found that the parent company relieved its subsidiaries of substantial costs, which, if the entities were not permitted to file on a combined basis, shifts and distorts the SunGard Group's income. Moreover, the Tribunal held that the savings associated with the consolidation of the SunGard Group's purchasing services was distortive because such reduced costs would not be available to individual members if they were engaged in discrete, stand-alone operations. In sum, the Tribunal found that disallowing the parent companies to be a part of the combined group was distortive because the income of each entity was directly affected by the relationship it had with the other entities.

Excluded from the Combined Group

In addition to the above, the Tribunal further found that several holding companies, two inactive corporations, and a corporation with only partnership income were properly excluded from the combined group. For the holding companies, the Tribunal observed that there was no flow of value between them and the rest of the members of the group, thereby severing any potential unitary relationship. The Tribunal further found that there was no evidence suggesting that the excluded holding companies were engaged in any of the group's business segments. For the inactive corporations, the Tribunal noted that there was no flow of value between them and the rest of the members of the combined group – so they were not unitary. Lastly, for the corporation with only partnership income, the Tribunal remarked how there was no evidence of the activities of the partnership generating the income, and thus the Tribunal could not determine whether it was unitary with the rest of the group.

The Department's argument is demonstrative of its historical attempt to exclude loss companies from the combined group in an effort to generate additional tax from the remaining members. However, for tax periods beginning on or after January 1, 2015, New York moved to a mandatory combined reporting system for unitary groups that satisfy the New York state ownership requirements. Accordingly, the application of this decision with respect to the distortion issue, and the Department's trend of de-combination, is likely diminished for future tax periods. Nevertheless, this ruling provides value for tax periods that remain open, in addition to determining how New York will likely consider future unitary analyses in the mandatory combined reporting regime. With respect to New York's unitary analysis, the state has historically provided relatively limited guidance on the fact-specific unitary construct. As a result of New York's new rules, this decision is valuable in providing guidance to many taxpayers that will likely want to consider whether they conduct a unitary business with related members in New York, and whether they will be required to file on a combined basis.

By Trevor R. Mauck, New York and David Pope, New York

Delaware Overhauls Major Provisions of its Abandoned and Unclaimed Property Law

On July 22, 2015, Delaware Governor Jack Markell signed Senate Bill 141 ("S.B. 141"), which overhauled major provisions of Delaware's Abandoned and Unclaimed Property Law. The bill was unanimously passed by the Delaware Senate and House of Representatives. *Tax News and Developments* issued a Client Alert on July 17, 2015, *Big Changes, New Opportunities for Delaware Holders of Unclaimed Property,* also available on the publications page at www.bakermckenzie.com, which discusses the amendments in detail. Now that the legislation has been enacted, Delaware holders should carefully consider how these changes may affect them and take advantage of all available opportunities to mitigate their Delaware unclaimed property exposure.

S.B. 141 substantially revises the Delaware Abandoned and Unclaimed Property Law by (1) reducing the look-back period for unclaimed property audits to 22 years beginning on January 1, 2017; (2) reinstating interest on unpaid amounts at 0.5% per month, capped at 25.0% of the amount due; (3) establishing a permanent voluntary disclosure agreement (“VDA”) program; (4) precluding the state escheator from initiating an audit of a holder until such holder has first been notified of the opportunity to participate in Delaware’s voluntary disclosure agreement program; and (5) imposing new reporting requirements.

Notwithstanding some of the unfavorable changes (i.e., interest on past due amounts, reporting requirements, etc.), the legislation does provide new opportunities for business entities formed under Delaware law. The look-back period under the new voluntary disclosure program is limited to 19 years with respect to any holder whose intent to enter into a VDA was accepted by the Delaware Secretary of State on or after January 1, 2017. This is an improvement from the look-back period of Delaware’s historical VDA programs, which generally required holders to file unclaimed property reports dating back to 1996. It is important that all Delaware holders who receive a notice from the Delaware Secretary of State act quickly to determine their path forward. There is a high likelihood that a holder will be selected for audit if no action is taken after receiving such notice, and the notice generally represents the holder’s final opportunity to pursue a voluntary disclosure agreement which can substantially reduce the amount of a holder’s historical unclaimed property liability. Under these new rules, a VDA may immediately reduce the look-back period by three years from what holders would likely face on audit. We also encourage all business entities formed under Delaware law to contact us to consider how this law change may affect them, and be used proactively, outside the context of a notice from the state.

By Matthew S. Mock, Chicago and Michael C. Tedesco, New York

Canadian Tax Update

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

Supreme Court Upholds Constitutionality of Civil Penalties in Income Tax Context

The Supreme Court of Canada released its much-anticipated decision in *Guindon v. Canada*, 2015 SCC 41, on July 31, 2015. Although the case deals with the validity of penalties applied to an individual tax preparer, its constitutional focus confirms legal principles applicable to all Canadian tax penalties, as well as penalties applicable to other fields of regulated activity.

The taxpayer in *Guindon* was assessed over $500,000 in 'tax preparer penalties' in respect of the making of false statements that could be used by third parties in their tax filings. By way of background, Ms. Guindon agreed to provide an opinion letter on the tax consequences of a particular leveraged donation program. Then, as president and administrator of the registered charity that functioned as the recipient of donations for the program, Ms. Guindon signed dozens of tax receipts issued by the charity to its donors. It was ultimately concluded that the donation program was a sham, and the CRA assessed Ms. Guindon penalties in respect of each of the issued tax receipts on the basis that she knew, or would have known but for willful disregard of the federal *Income Tax Act*, that the tax receipts constituted false statements.

The trial judge agreed with the CRA that Ms. Guindon would reasonably have been expected to know that the tax receipts were false at the time she signed them. However, this was not the end of the matter: Ms. Guindon also challenged the penalties on the basis that they constituted criminal or penal offences that engaged her rights under the *Canadian Charter of Rights and Freedoms* (such as the right to be presumed innocent until proven guilty beyond a reasonable doubt). That civil-criminal divide is important because it affects everything from a taxpayer's appeal rights to the reach of the CRA's audit powers. Although the trial court sided with Ms. Guindon on the *Charter* issue, both the first-level appeal court and the majority of the Supreme Court of Canada concluded that the disputed penalty was a valid administrative monetary penalty (or "AMP") and did not engage the constitutional protections Ms. Guindon sought. Some key takeaways from the Supreme Court's decision are:

(i) Even exceedingly large, multi-million dollar penalties will not necessarily engage constitutional protections. A penalty will only trigger *Charter* rights where a proceeding is criminal by its very nature, or where true penal consequences flow from the provision in question. The "criminal in nature" test looks to both the purpose of the proceeding (e.g. promoting public order in a public sphere of activity vs. regulatory compliance in a limited sphere of activity) and to the particular procedures imposed. In contrast, the "true penal consequences" test considers the quantum of a penalty as one of a number of factors relevant to determining its characterization (e.g. the penalty's magnitude, to whom the amount is paid, how the amount is set, and what stigma is associated with the penalty).

(ii) Although the tax preparer penalty in issue in *Guindon* has been upheld as constitutional, this does not mean that other Canadian tax penalties (or civil penalties in other regulatory schemes, such as in the customs context) are safe from constitutional challenge. The penalties most susceptible to such challenge may be AMPs that impose a large fine while also incorporating criminal sentencing principles, such as denouncing unlawful conduct (either by leaving this to the regulator's discretion or by reference to the legislative intention underlying the provisions in issue). When facing a potential penalty, however, taxpayers should also keep in mind the robust appeal rights to which they have access in Canada, as well as additional recourses of discretionary relief (e.g. the CRA's taxpayer relief program, and the possibility of seeking a remission order from tax debts that are unreasonable or not in the public interest).

(iii) There is potential for extremely large civil penalties in the Canadian tax context (especially in areas such as transfer pricing). As a result, taxpayers should remain cognizant of their penalty exposure at all times and should take active steps to ensure compliance on the front end by carefully maintaining their records and making all filings with the CRA in a timely manner.

By Mark Tonkovich, Toronto

Anson v. HMRC: UK Tax Treatment of Delaware LLCs

The recent decision of the UK Supreme Court in *Anson v. Commissioners for Her Majesty's Revenue and Customs* has created considerable uncertainty for international group structures by ruling that the profits of a Delaware LLC belonged to its members as those profits arose. In other words, the Delaware LLC in this case was treated as "transparent" for certain UK tax purposes, a position that runs counter to the prevailing practice of HM Revenue & Customs (HMRC).

The decision creates uncertainty in three areas. First, UK resident members of Delaware LLCs (and other entities with similar characteristics) may now be subject to UK tax on the profits of the LLC as they are earned, as opposed to when they are distributed by the LLC. Second, it is now unclear whether a Delaware LLC can be a member of a "group" for UK tax purposes. Finally, the decision creates uncertainty in relation to the availability of double tax relief.

It is our hope that these uncertainties will be addressed through prompt legislative amendment, where appropriate with retroactive effect. Based on discussions with HMRC, we expect a reaction to the decision and an outline of proposals to address the uncertainty it has caused to be released towards the end of the summer.

The facts of *Anson v. HMRC*

Mr. Anson was a US citizen who was resident for tax purposes in the UK. He was a member of a Delaware LLC that carried on an investment management business in the US, managing various venture capital funds. Mr. Anson was assessed to US tax on his share of the profits of the LLC. The balance of the profits were distributed to him, and in computing his UK tax liability on those profits he claimed credit relief for the US tax under Article 23(2) of the UK/US double tax treaty (the "Treaty"). Article 23(2) allows relief from UK tax for US tax "computed by reference to the same profits or income." HMRC challenged his claim for double tax relief on the basis that the income which had been taxed in the US was not his income, but that of the LLC.

The LLC Operating Agreement of the LLC appears to have been fairly standard. It contained a section providing for the profits of the LLC to be allocated among the members in accordance with their profit shares. It also contained a section providing for distributions of all of the profits of the LLC to be made to the members each year "in such amounts as the managing members may determine in their sole discretion."

The decision of the UK Supreme Court

In hearing the case at first instance, the UK First-Tier Tribunal (FTT), finding in favor of the taxpayer, had found as a matter of fact that, on a proper construction of Delaware law and the LLC Operating Agreement, the members of the LLC had an interest in the profits of the LLC as they arose. Put another way, the FTT found as a matter of Delaware law that the profits (as opposed to the assets) of the LLC did not belong to the LLC in the fist instance and then become the profits of the members as a result of some mechanism for the change in ownership (e.g. the declaration of a dividend). Rather, the profits of the LLC belonged to the members as they arose.

The decision of the FTT was overturned in the Upper Tribunal and, on appeal by the taxpayer, in the Court of Appeal, in each case on the basis that the FTT had erred in its application of UK tax law to the facts.

The Supreme Court, by contrast, found that Mr. Anson had an interest in the LLCs profits as they arose, and was therefore entitled to double tax relief, thus reinstating the decision of the FTT.

The Supreme Court's decision can be read broadly or narrowly. The broad view is that *Anson v. HMRC* is authority for the position that under UK tax law the key factor in determining the proper classification of any foreign entity is whether the members of the entity have an interest in the profits as they arise. This broad view potentially has a number of UK tax implications, described further below.

The narrow view is that the Supreme Court merely decided that the FTT's findings of Delaware law were findings of <u>fact</u> and not law, and as such were not amenable to being overturned on appeal. On this view, the scope of the decision would arguably be limited to the particular Delaware LLC in question.

The relevance of foreign entity classification in UK tax law and the implications of *Anson v. HMRC*

The classification of foreign entities for UK tax purposes is relevant principally for three purposes:

1. **Who is assessed to UK tax**. A foreign entity that is treated as "transparent" for UK tax purposes is not subject to UK tax. Rather, its members are subject to tax on the profits of the entity as they arise, essentially in the same way as a partnership. Prior to the decision in *Anson*, HMRC's established view was that Delaware LLCs should be treated as "opaque," such that its members would only be subject to tax on its profits once those profits are distributed, essentially in the same way as a corporation. In light of *Anson*, UK resident members of Delaware LLCs (and comparable entities) could be assessed to tax on the undistributed profits of the LLC. Similarly, LLCs with non-UK resident members that had previously been treated as tax resident in the UK based on being managed and controlled in the UK may now escape UK corporation tax altogether.

2. **UK tax "grouping."** For many UK tax purposes, a "group" of companies is traced through the "issued share capital" of the corporate entities in the

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chain of ownership up to the parent. Prior to *Anson*, HMRC's position had been that members' interests in Delaware LLCs were akin to "issued share capital", such that the group relationship could be traced through an LLC. The FTT in *Anson*, by contrast, held that members' interests in the LLC were not akin to share capital, but were more like interests in a partnership. The *Anson* decision therefore throws considerable doubt on whether an LLC can be a member of a UK tax group. This could have serious implications for groups that have transferred shares or assets between UK group members where the "group" was traced through a Delaware LLC or similar entity. Such groups could now be facing significant tax charges.

3. **Double tax relief**. Finally, read narrowly, the decision creates uncertainty for the availability of double tax relief. If the decision in *Anson* is limited to its particular facts, this would potentially prevent taxpayers in similar circumstances from applying the same treatment, and obtaining double tax relief for UK tax imposed on profits derived through a similar foreign entity.

HMRC is known to be considering the implications of *Anson* and whether to adopt the broad or narrow interpretation described above. While the narrow approach would arguably preserve the status quo in many cases, it creates significant uncertainty for taxpayers. We have articulated this concern to HMRC. Adopting the broader approach, by contrast, could have material collateral consequences (such as the "degrouping" issue described above) that are not in the interests of either HMRC or taxpayers. For this reason, we believe, and have argued to HMRC, that legislative amendment to clarify the uncertainties caused by *Anson* should be pursued urgently.

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

Getting Better All the Time…Baker & McKenzie Adds Top Economists in New York and Silicon Valley

Baker & McKenzie is pleased to announce the recent arrival of two leading economic and transfer pricing advisors to its ranks in North America. Brian Cromwell has returned to Baker & McKenzie Consulting LLC as a Principal Economist in the Firm's Palo Alto office, and Shane Koball joins as a Director of Economics on the opposite coast in the Firm's New York office.

With more than 25 years of experience and a Ph.D. in Economics, **Brian Cromwell** has focused his practice in the valuation of intangibles associated with the technology and marketing for multinational clients in a number of key industries, including technology, pharmaceutical, life sciences, and consumer products. He also has extensive experience in the evaluation, support and defense of intangible transfer pricing positions as part of tax controversy and FIN 48 reviews, and advises clients on Advance Pricing Agreements and the design and implementation of global transfer pricing strategies.

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Brian joins a global group of valuation specialists that focus on intellectual property valuation, enterprise valuation, and valuation of specific assets, liabilities, rights, and obligations. As the only law firm able to provide an in-house valuation services team, his experience compliments the well-rounded group of valuation professionals located in Chicago, New York, Washington, DC, Palo Alto, Toronto, London, Amsterdam, Dusseldorf, Mexico City, and Shanghai.

Brian received his B.A. in Economics from Swarthmore College before earning his Ph.D. in Economics from Massachusetts Institute of Technology in 1989. He received the National Tax Association Award for Outstanding Doctoral Dissertation in the same year.

Shane Koball joined the Firm's New York office, also from a Big 4 accounting firm, where he focused on supply chain restructuring, regularly teaming with colleagues in international tax, customs and indirect tax, and business advisory services. With several years of experience in transfer pricing planning, policy, compliance and dispute resolution, Shane is a welcome addition in New York where he will work closely with Phil Carmichael (Principal Economist, New York) and the Firm's award-winning transfer pricing practice on the management of US and global transfer pricing documentation and planning projects, including advising multinational clients on supply chain planning and controversy preparation. Shane earned his B.A. from Seattle University and a Master of Arts in Economics from The New School for Social Research (New York).

The addition of Brian and Shane bolsters Baker & McKenzie's well-established global economics practice, which consists of more than 30 practitioners based in North America and approximately 100 worldwide. Transfer pricing continues to be an important tax topic for many of our multinational clients, and as a firm offering an integrated legal and economics team dealing with transfer pricing matters on a daily basis, Baker & McKenzie is able to provide a robust global transfer pricing practice to meet our clients' needs.

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