Tax News and Developments

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In This Issue:

OECD Releases Final Reports In Most Significant Effort to Revise the International Tax Framework in a Century

On October 5, 2015, the Organisation for Economic Co-operation and Development ("OECD") issued a final package of measures in the Base Erosion and Profit Shifting Project ("BEPS"). The OECD and G20's goal is to "change the paradigm" by moving away from double non-taxation of income to better align where profits are taxed with the location where value is created, all while avoiding double taxation. The OECD estimates that BEPS results in global corporate income revenue losses of $100-240 billion annually, so interest in implementing the BEPS measures is high in both OECD/G20 countries and the developing world.

The BEPS package establishes "minimum standards" in several key areas that OECD and G20 member countries have agreed to implement in a systematic and consistent fashion and develops "building blocks" and "best practices" in other areas that countries may choose to implement (although they are not obligated to do so). And BEPS isn't over—the OECD expects to do follow-up work on several topics in 2016 and 2017, and will review implementation of the minimum standards and publish a report by 2020.

Countries have agreed to "minimum standards" on standardized Country-by-Country ("CbC") reporting and other transfer pricing documentation requirements, the development of model provisions to prevent treaty abuse through treaty shopping, improving dispute resolution, and addressing preferential IP regimes through a nexus approach. Some of these standards—such as CbC reporting—may be implemented immediately in some jurisdictions, while others will require domestic law or treaty changes. Areas where countries could not agree on minimum standards, but have agreed to work on "common approaches," are the appropriate treatment of hybrid mismatch arrangements, limitations on interest deductions, disclosure of aggressive tax planning, standardizing the collection of data on BEPS, and preventing the artificial avoidance of a permanent establishment. In 2016, the OECD will work on a multilateral instrument to incorporate some of these changes into more than 3000 tax treaties.

Stay tuned for forthcoming in-depth analysis of these game-changing reports.

By Joshua D. Odintz and Alexandra D. Minkovich, Washington, DC

Upcoming Tax Events

- **TEI International Tax Day**

  Irvine, California
  October 29, 2015

  Seattle, Washington
  November 3, 2015

- **TEI Austin/Baker & McKenzie Tax Workshop**

  Austin, Texas
  November 13, 2015

- **Asia Pacific Tax Conference**

  Singapore
  November 19-20, 2015

- **SALT Roundtable**

  Minneapolis, Minnesota
  December 3, 2015

- **North America Tax Workshop**

  Miami, Florida
  January 29, 2016

- **VAT Webinar Series 2015-2016**

To review the complete Tax Events Calendar visit www.bakermckenzie.com/tax/event

IRS and Treasury Issue Controversial Proposed Regs under Section 367 and Temporary and Final Regs under Section 482

On September 14, 2015, and in the midst of numerous taxpayer disputes that are pending at both the administrative and the judicial levels, the IRS issued proposed Treasury Regulations under Code Sections 367(a) and 367(d) that would prevent taxpayers from being able to transfer foreign goodwill or going concern value in an outbound transfer on a tax-free basis ("Proposed Section 367 Regulations"). At the same time, and in conjunction with the release of the Proposed Section 367 Regulations, the IRS and Treasury issued Temporary and Final Regulations under Code Section 482 (collectively, the "Section 482 Regulations"). The validity of the Proposed Section 367 Regulations and the Section 482 Regulations is already being questioned.

Section 367(a) and the regulations thereunder preclude non-recognition treatment for certain transfers of property to foreign corporations. Transfers falling under section 367(a) are subject to immediate tax on the gain in the transferred assets. However, a major exception to the general rule applies for taxpayers making outbound transfers of property if the receiving foreign corporation will use such property in an active trade or business ("ATB Exception").

Section 367(d) provides in the alternative that, for certain intangibles set out in section 936(h)(3)(B), a taxpayer making a transfer in a section 351 or section 361 exchange may elect to recognize an income stream over the useful life of the intangible, which has been historically limited to a maximum of 20 years. While it remains unresolved whether foreign goodwill and going concern value are section 936(h)(3)(B) intangibles, existing Temporary Regulations under section 367(d) provide that foreign goodwill and going concern value are not subject to section 367(d).

Applying these rules, taxpayers have been able to take the positions that outbound transfers of foreign goodwill and going concern value are only subject to section 367(a) and the regulations thereunder. Furthermore, taxpayers have been able to rely on the ATB Exception to receive non-recognition treatment on the transfer of such intangible assets.

The IRS and Treasury expressed concern in the preamble to the Proposed Section 367 Regulations that taxpayers were using these provisions and "aggressive" valuation methods to categorize an inappropriate portion of the value of property transferred in an outbound transaction as foreign goodwill and going concern value in order to minimize their tax exposure. The preamble also set out the concern that taxpayers were overly broad in their interpretation of foreign goodwill and going concern value in the section 367 context. While the existing regulations define foreign goodwill and going concern value by reference to businesses operations outside the US, the IRS and Treasury expressed a desire to exclude activities conducted primarily in the US on behalf of foreign customers from increasing the value of foreign goodwill and going concern value. The preamble explains the IRS and Treasury position that, while the legislative history of section 367 and the regulations thereunder show congressional intent to allow for foreign goodwill and going concern to be transferred without immediate gain recognition, the IRS and Treasury believe the taxpayer positions under the existing section 367(a) and 367(d) provisions are inconsistent with the expectation that allowing for non-recognition in this context would not lead to tax abuse.

The Proposed Section 367 Regulations modify the provisions and effectively require that taxpayers recognize gain on the transfer of foreign goodwill and going concern value to foreign corporation. The Proposed Section 367 Regulations do not resolve whether foreign goodwill and going concern value is a section 936(h)(3)(B) intangible but instead require that taxpayers choose to apply either section 367(a) or 367(d) to any property that is being transferred in an outbound transaction and that is not a section 936(h)(3)(B) intangible or property that is eligible for the ATB exception.

In the section 367(a) context, the Proposed Section 367 Regulations limit the applicability of the ATB Exception under section 367(a) to tangible property, working interests in oil and gas property and certain financial assets, in each case, other than (1) inventory or similar property, (2) installment obligations, account receivable or similar property, (3) foreign currency or certain other property denominated in foreign currency, and (4) certain leased tangible property. Therefore, intangible assets, including foreign goodwill and going concern value, will not be eligible for the ATB exception under the Proposed Section 367 Regulations.

In the section 367(d) context, the Proposed Section 367 Regulations eliminate the section 367(d) exception for foreign goodwill and going concern value. Furthermore, for taxpayers electing to recognize the income under the section 367(d) approach, the 20 year limit on the useful life of the intangible would be eliminated.

The Proposed Section 367 Regulations provide for a 90-day notice and comment period and if finalized, will be effective as of September 14, 2015. The final Treasury Regulations will have retroactive effect with regard to any transfer made after September 13, 2015.

The existing regulations under section 482 authorized the Secretary of the Treasury to adjust the tax results of controlled transactions to properly allocate income amongst commonly controlled taxpayers using an arm's length standard. With regard to transfers of intangibles, the arm's length result is determined by applying the “best method” to determine the income attributable to such intangible property. The IRS and Treasury expressed concern in the preamble to the Section 482 Regulations that, absent coordinating regulations, taxpayers may be able to combine the regulations under section 482 and other sections, including section 367, to achieve results unintended by the Code and regulations. Particularly, the preamble expressed the concern that arm's length results may not be achieved where taxpayers apply the “best method” approach narrowly to transactions that are interrelated.

The new Section 482 Regulations apply when (1) two or more controlled transactions are interrelated and (2) controlled transactions implicate two or more provisions of the Code or regulations. Under the new regulations, when a transaction is a controlled transaction under the section 482 rules, and also subject to another Code provision, such as section 367(a) or 367(d), the taxpayer must use the valuation method that is the most reliable measure of an arm's length result. The new Section 482 Regulations take a three pronged approach in achieving this goal. First, the regulations require that taxpayers determine the economic value of controlled transactions in the aggregate where an aggregate approach leads to a more appropriate measure of an arm's length result. When conducting such analysis, taxpayers must take into account controlled transactions that are economically interrelated and determine the overall value between controlled taxpayers. This analysis includes taking into account any synergies created by the interrelated transactions to determine the total value of the transactions from an economic substance perspective, regardless of the form of the transaction. Second, under the new regulations, taxpayers must take a coordinated approach in applying the "best method" analysis to two or more controlled transactions. This coordinated approach is intended to determine the total value of the controlled transactions more effectively than the approach allowed under the existing regulations. The third consideration for taxpayers under the new Section 482 Regulations is that the total value determined through aggregating the transactions must be allocated discretely between the controlled taxpayers using the coordinated "best method" approach. This differs from the existing regulations by broadening the Commissioner's powers to allocate the total value determined through aggregation between the controlled parties. The new Section 482 Regulations also provide seven new examples illustrating the application of these regulations to various fact patterns. The Section 482 Regulations apply to taxable years ending on or after September 14, 2015.

The Section 482 Regulations may exceed the IRS's authority under section 482. The regulations focus on value creation and profits, some of which may not arise from any controlled transaction. For example, inherent in the approach is capturing the value of a "business opportunity" the foreign affiliate is exploiting. The Tax Court held in *Hospital Corporation of America v. Commissioner* that allowing a foreign affiliate to exploit a business opportunity is not a transfer of property under sections 482 or 367(d). The new Section 482 Regulations attempt to convert an analysis of pricing of transactions into a valuing of relationships. The IRS has not presented any evidence that unrelated parties acting at arm's length would use a similar approach to price transactions.

Likewise, taking into account the legislative history behind section 367 and Congress' historical intent that no gain would be recognized on the transfer of foreign goodwill or going concern value to a foreign corporation, it is unclear whether the Proposed Section 367 Regulations would survive a challenge to their validity. Notwithstanding the IRS and Treasury position, the legislative history is clear that there is intended to be an exception under section 367(d) for these intangibles. If the regulations when finalized reflect the Proposed Section 367 Regulations in their current form, taxpayers will need to carefully consider whether the section 367(a) or 367(d) approach would be more beneficial for outbound transfers of foreign goodwill and going concern value.

Taxpayers must be prudent in considering how this recent regulatory activity, along with the results of the various pending judicial disputes that are currently addressing the interplay between sections 367 and 482, may alter the results of their tax planning going forward.

By Michael J. Bruno and Sean J. Tevel, Miami

NOTE: Since the original publication of this newsletter (October 27, 2015) we have added the highlighted language to the following sentence: The Proposed Section 367 Regulations do not resolve whether foreign goodwill and going concern value is a section 936(h)(3)(B) intangible but instead require that taxpayers choose to apply either section 367(a) or 367(d) to any property that is being transferred in an outbound transaction ***and that is not a section 936(h)(3)(B) intangible or property that is eligible for the ATB exception****.*

New Section 956 Regs Expand Anti-Abuse Provision, Application to Partnerships

On September 2, 2015, the Treasury Department and IRS published concurrent Temporary and Proposed Regulations under Code Section 956 that significantly expand the scope of the provision with regards to CFC investments in US property. The new guidance, among other changes, modifies the pre-existing anti-abuse rule by removing restrictions on the methods of funding that can trigger the provision and extends the application of section 956 to various partnership transactions.

Section 956, via section 951(a)(1)(B), requires that a US shareholder include in income a pro rata share of the CFC's investments in US property. Such investments can include both tangible or intangible property located or used in the United States, as well as debt obligations of related domestic corporations or US shareholders. These investments have the effect of repatriating foreign earnings for the benefit of US shareholders, and section 956 therefore taxes US shareholders on their pro rata "section 956 amount." The "section 956 amount" is equal to the lesser of the US shareholder's pro rata share of (1) the CFC's "applicable earnings," or (2) the average amounts of US property held directly or indirectly by the CFC as of the close of each quarter, less previously taxed income. A CFC's "applicable earnings" are the sum of current and accumulated earnings and profits, less any distributions and previous inclusions under section 951.

The anti-abuse rule in Temp. Reg. § 1.956-1T(b)(4) is aimed at preventing CFCs from circumventing section 956 by transferring US property to, or conducting investments in US property through, other foreign corporations controlled by the CFC. Absent this provision, US shareholders could reduce or eliminate their section 956 amount through use of controlled foreign entities that either have no earnings and profits, or simply have lower earnings and profits than the original CFC, resulting in a correspondingly lower section 956 amount due to the applicable earnings limitation in the section 956 calculation. Both the prior and new versions of the section 956 regulations addressed these methods of circumvention by providing the IRS with a mechanism to attribute, in certain circumstances, the investment in US property to a CFC not directly holding the investment. The anti-abuse rule provides that, for purposes of section 956, US property held indirectly by a CFC includes US property acquired by another foreign corporation controlled by the CFC if a principal purpose of creating, organizing, or funding the other foreign corporation is to avoid the application of section 956 with respect to the CFC.

The new Temporary Regulations, set forth in T.D. 9733, modify the anti-abuse rule in several critical respects. First, the Temporary Regulations extend the anti-abuse rule to partnerships where the prior regulations, by their terms, only applied to creating, organizing, or funding a foreign corporation. Further, new Temp. Reg. § 1.956-1T(b)(5) targets situations where a CFC will fund (or guarantee) a borrowing by a foreign partnership for the purpose of a partnership distribution to a US partner that is related to the CFC if such partnership would not have made the distribution "but for" the funding. In this situation, the Temporary Regulations impose an aggregate approach and treat the partnership obligation as an obligation of the distributee US partner to the extent of the lesser of (1) the amount of the distribution that would not have been made "but for" the funding of the partnership, or (2) the amount of the foreign partnership obligation. Second, perhaps the most significant modification made by the Temporary

Regulations is the expansion of the kinds of funding that will trigger the anti-abuse provision. The prior regulations limited the applicable “funding” of a foreign corporation to capital contributions and debt. However, the Temporary Regulations no longer contain such a limitation, and instead refer to “funding by any means (including through capital contributions or debt).”

The amendment to the funding definition appears contrary to the original purpose of the anti-abuse rule. The limitation to capital contributions and debt originates in the 1988 version of the regulation (T.D. 8209), the preamble to which reflected the drafters’ concern that foreign corporations could separate cash from earnings and profits in order to decrease or eliminate the section 956 amount. Only certain methods of funding, such as debt and capital contributions, will create this separation of cash and earnings and profits, while funding through, for example, dividend distributions would not, due to the resulting reduction in earnings and profits. Thus, the expanded definition of “funding” could bring within the scope of section 956 transactions that do not implicate the original policy of the anti-abuse rule.

The expansion of the methods of funding that will trigger the anti-abuse rule has effectively transformed this rule into a “principal purpose” test. Because the forbidden methods of funding are no longer limited to capital contributions or debt, the analysis of the rule’s application will now solely be focused on the intent of the CFC and its purpose for creating, organizing, or funding the foreign corporation or partnership. This shift is highlighted by the modifications to the examples in the regulations. Examples 1 and 2 in the regulations concern two wholly owned CFCs with the same US parent. The first CFC has significant E&P, while the second CFC has none. The first CFC sells inventory to the other in exchange for trade receivables due in 60 days. The second CFC then extends a loan to the US parent in the amount of the trade receivables. In the first example, the second CFC repays the receivables according to their terms. On these facts, the example concludes that the anti-abuse rule is not triggered. In the second example, the facts are the same except that the second CFC does not repay the receivables. As a result of the changed facts, the example concludes that the anti-abuse rule applies, presumably because the first CFC has made a capital contribution to the second CFC.

The examples were retained in the Temporary Regulations and reach the same conclusions, but were revised in an important manner. Under the prior regulations, there was no mention of the principal purpose for the transactions in the facts, and the first example concluded that the anti-abuse rule was not triggered because there was “no transfer of funds” to the second CFC, *i.e*., no funding. Presumably, the drafters believed that a short-term trade receivable paid according to its terms was more like cash, so there was no “funding” because there was no loan. *Cf*. Temp. Reg. § 1.956-2T(d)(2)(i)(B) (excluding from the definition of “obligation” certain short-term intercompany receivables that are repaid within 60 days). In contrast, in the second example, the anti-abuse rule applied because (i) there was now a “transfer of funds” to the second CFC, *and* (ii) the “principal purpose” for such transfer was the avoidance of section 956. As to the principal purpose element, the example appeared to simply infer the purpose from the facts of the transaction. Under the Temporary Regulations, the facts of both examples specifically add the principal purpose for the transaction – in the first example, there is no principal purpose to avoid section 956, while in the second example, there is such a purpose. Thus, the conclusions of both examples now directly follow once the principal purposes are provided. The “transfer of funds” language was removed from both examples, and the first example specifically provides that the trade receivables are now considered a “funding” even when paid according to their terms. This change demonstrates that it is no longer the form of funding that is relevant, but instead the underlying purpose of the transaction.

Repositioning the focus of the analysis on the principal purpose of the creation, organization, or funding of the foreign corporation creates an obligation for the IRS to establish the CFC’s subjective principal purpose. While the prior limitation on types of funding confined the scope of the rule to transactions that inherently avoided application of section 956 by separating cash from earnings and profits, the Temporary Regulations apply to transactions where such intent cannot be inferred as easily from conduct. Thus, the IRS now will have the increased burden of proving such intent based on other factors. While the preamble states that the CFC’s tax attributes associated with a section 956 inclusion, such as total and previously taxed earnings and profits and foreign tax credit pools, are taken into account in determining the principal purpose of funding, the examples do not provide significant guidance as to the nature of that inquiry.

In addition to mirroring the Temporary Regulations (Temp. Reg. § 1.956-1T), the Proposed Regulations also add significant material to 1.956-2, -3, and -4 with respect to partnerships. The preamble to the Proposed Regulations makes clear Treasury’s policy to treat an obligation of a foreign partnership as an obligation of its partners for purposes of section 956, subject to an exception for obligations of foreign partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner. The Proposed Regulations therefore are intended to effect this policy and include detailed rules for determining the partner’s share of the partnership obligations and the treatment of pledges and guarantees in the partnership context. While most of the rules are intended to apply to property acquired, or pledges or guarantees entered into, on or after September 1, 2015, only §§ 1.956-2(a)(3), 1.956-4(e), and 1.956-4(b) are proposed to apply to obligations held or property acquired on or after the date of publication of the Treasury decision adopting these rules as final regulations. These provisions concern obligations of disregarded entities and domestic partnerships as well as partnership property indirectly held by a CFC.

By Kathryn Rimpfel and Daniel V. Stern, Washington, DC

Notice 2015-54: IRS Attacks Transfers of Property to Partnership with Related Foreign Partners and Controlled Transactions Involving Partnerships

As every tax practitioner knows, the use of partnerships in business transactions has been growing by leaps and bounds. It is exceedingly common for the parties in a cross-border transaction to form a partnership where, in the past, they would have formed a corporation to engage in such business. This growth has been particularly evident in cross-border transactions involving related party partnerships, where property is transferred to partnerships with foreign persons.

Such cross-border transactions involving partnerships are the focus of the IRS’s Notice 2015-54, published on August 6, 2015 (the "Notice"), in which the IRS announced that it would soon issue regulations under Code Section 721(c) to ensure that when a US person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The Notice also announced the IRS and Treasury's intent to issue regulations under Code Sections 482 and 6662, applicable to controlled transactions involving partnerships, to ensure appropriate valuation of such transactions.

These regulations will contain a retroactive effective date, i.e., they will apply to transfers occurring on or after August 6, 2015, and to transfers occurring before August 6, 2015, resulting from entity classification elections that are filed after that date but which are effective before August 6, 2015.

Background

Partnership Allocations under Code Section 721

Section 721(a) provides a general rule that "no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Therefore, this nonrecognition provision allows the contribution of appreciated property to any partnership (domestic or foreign, related or unrelated) without significant current US federal income tax consequences. However, section 721(c) grants the IRS the authority to issue regulations to override the nonrecognition provision of section 721(a) with respect to gain realized on the transfer of property to a partnership (domestic or foreign) "if such gain, when recognized, will be includible in the gross income of a person other than a United States person."

The Notice announced the IRS's intent to finally issue regulations under section 721(c) to ensure that, when a US person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the contributed property will be taken into account by the transferor either immediately or periodically. These new rules are part of the US government's recent efforts to prevent taxpayers from moving high-profit intangibles offshore.

Code Section 482

Section 482 (and the regulations promulgated there-under) are the source of the US transfer pricing rules, which aim to prevent tax evasion and ensure that taxpayers clearly reflect income relating to transactions between controlled entities. Section 482 authorizes the IRS to allocate gross income and other items (deductions, credits, allowances, basis, etc.) between commonly controlled (i.e., related) entities if necessary to prevent tax avoidance or to reflect clearly the entities' income attributable to controlled transactions. The true taxable income earned through intercompany transactions is determined by placing a controlled taxpayer on parity with an uncontrolled (i.e. independent) taxpayer. This objective is achieved by testing whether the transactions between related parties (for tax purposes) are conducted at arm’s length.

Proposed Regulations under Section 721(c)

Overview of Proposed Regulations under Section 721(c)

The new regulations under section 721(c) would override the general nonrecognition treatment provided by section 721(a) when a US transferor contributes property with built-in gain, to a partnership with a related foreign partner, unless the “Gain Deferral Method” is applied with respect to the contributed property. From a subchapter K perspective, the primary impact of the Notice and the new regulations is the requirement for US taxpayers in such scenarios to conform to the "Gain Deferral Method" including adoption of the remedial allocation method (as described in Treas. Reg. § 1.704-3(d)).

These requirements, as discussed below, do not appear to radically change the manner in which partnerships operate in such cross-border transactions, as many taxpayers already use the remedial method, a rather practical method, to allocate built-in gain or loss on property contributed to the partnership. Briefly, the following are the requirements of the Gain Deferral Method, as set forth in Section 4.03 of the Notice:

1. The partnership adopts the remedial allocation method for built-in gain with respect to contributed property.

2. The partnership allocates all items of section 704(b) income, gain, loss, and deduction with respect to the contributed property the same proportion in each taxable year.

3. All reporting requirements are satisfied.

4. The US transferor recognizes the built-in gain upon an Acceleration Event (i.e. any transaction that either would reduce the amount of remaining built-in gain or could defer the recognition of the built-in gain).

5. For a specified period of time, the Gain Deferral Method is adopted for all subsequently contributed property with built-in gain.

The Remedial Allocation Method

The key component of the Gain Deferral Method (as mentioned above) is the requirement for a partnership to use the remedial allocation method for built-in gain with respect to all contributed property. The IRS believes that remedial allocations can have the effect, in part, of ensuring that pre-contribution gain from contributed property is properly taken into account by the US contributing partner, rather than shifted to the noncontributing partner.

By way of background, in general, under section 704(a), a partner's distributive share of the partnership's income, gains, losses, deductions and credits is determined by the partnership agreement. However, in order to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss, section 704(c), and the regulations promulgated thereunder, provide special rules for allocations of built-in gain or loss on property contributed to the partnership by a partner. Section 704(c)(1)(A) requires partnerships to allocate income, gain, loss, and deduction with respect to property contributed by a partner using any reasonable method so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution (i.e. built-in gain or loss). Treas. Reg. §1.704-3 describes three methods of making section 704(c) allocations that are generally reasonable: (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method.

Treas. Reg. §1.704-3(d) provides that the remedial allocation method is used to eliminate distortions caused by the ceiling rule when applying the traditional method for the allocation of pre-contribution gain or loss on contributed property. Such distortions are eliminated by making remedial allocations of income, gain, loss, or deduction to the noncontributing partners equal to the full amount of the limitation caused by the ceiling rule, and offsetting those allocations with remedial allocations of income, gain, loss, or deduction to the contributing partner. Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest.

Essentially, the goal under this method is to keep the noncontributing partner's book and tax allocation of deductions with respect to 704(c) property the same. As a result, the contributing partner would recognize any built-in gain or loss when (and to the extent) the partnership claimed increased or decreased depreciation deductions, or earlier if the partnership disposed of the property in a taxable transaction or the contributing partner's interest in the partnership was reduced.

Proposed Regulations under Section 482

The Notice indicates that section 482 and penalty provisions, as they currently stand, do apply to controlled transactions involving partnerships. For instance, where US and foreign persons under common control enter into a partnership, the amounts of their contributions to, and distributions from, the partnership are subject to adjustment in order to reflect arm’s length results.

The application of section 482 is also seen in provisions relating to partnerships. For example, section 1.704-1(b)(1)(iii) provides that, even if an allocation of partner's distributive share based on the partnership agreement is respected under sections 704(a) and 704(b), the distribution may still be reallocated under other provisions, such as section 482. *See* also *Rodebaugh v. Commissioner*, T.C. Memo. 1974-36, (holding that the Commissioner could make allocations under section 482 that differed from the formula set forth in the partnership agreement), aff’d, 518 F.2d 73 (6th Cir. 1975). Nevertheless, the IRS intends to augment the current transfer pricing regulations to directly apply certain Section 482 regulations to controlled transactions involving partnerships.

Specifically, The Treasury Department and the IRS intend to issue regulations regarding the application to controlled transactions involving partnerships of certain rules in Treas. Reg. § 1.482-7 that are currently applicable to cost sharing arrangements. The rules would adopt the specific methods prescribed in the regulations, and also provide periodic adjustment rules that are based on the principles of Treas. Reg. §1.482-7(i)(6) for controlled transactions involving partnerships.

The Treasury Department and the IRS also are considering issuing regulations under Treas. Reg. § 1.6662-6(d) to require additional documentation for certain controlled transactions involving partnerships. These regulations may require, for example, documentation of projected returns for property contributed to a partnership (as well as attributable to related controlled transactions) and of projected partnership allocations, including projected remedial allocations, for a specified number of years.

By Richard M. Lipton, Chicago and Sahar Zomorodi, New York

IRS Issues Guidance Addressing Certain Spin-off Transactions

On September 14, 2015, the IRS issued Notice 2015-59 (the "Notice") and Rev. Proc. 2015-43 (the "Rev. Proc.") addressing spin-off transactions where the active business of the distributing or controlled corporation is small or the amount of investment assets of either company is large. The Notice alerts taxpayers that spin-offs involving these facts raise concerns and previews the arguments that the IRS may make to attack them. The Rev. Proc. provides that the IRS will no longer issue rulings on these types of transactions, effective for any ruling request sent on or after September 14, 2015.

The Notice and Rev. Proc. describe three categories of spin-off transactions that it finds troubling. The categories do not distinguish between pro rata and non-pro rata spin-offs. Thus, either type could be subject to this new guidance.

The first category of transactions described in the Notice includes distributions where: (i) the distributing corporation or the controlled corporation owns a substantial amount of cash, portfolio stock or securities, or other investment-type assets in relation to the value of its assets used to satisfy the active trade or business test under Code Section 355 (such assets, "Qualifying Business Assets"), and (ii) one of the corporations has a significantly higher ratio of investment assets to non-investment assets than the other. The Notice clarifies that the IRS is less concerned with distributions that occur entirely within an affiliated group.

The Rev. Proc. states that the IRS is continuing to study transactions that fall into this category, and in the meantime will not issue rulings with respect to distributions where: (i) the fair market value of the investment assets of the distributing corporation or the controlled corporation is two-thirds or more of the total fair market value of its gross assets, (ii) the fair market value of the distributing or controlled corporation's Qualifying Business Assets is less than 10 percent of the fair market value of its investment assets, and (iii) the ratio of the fair market value of the investment assets to the fair market value of the non-investment assets of the distributing corporation or the controlled corporation is three times or more such ratio for the other company. For purposes of measuring these asset values, the distributing and controlled corporations are generally treated as owning directly the assets of 80-percent owned subsidiaries. The Rev. Proc. provides that this no-rule policy also extends to spin-offs in which investment assets are disposed of or Qualifying Business Assets are acquired with a principal purpose of avoiding these thresholds. There is an exception in the Rev. Proc. for spin-offs occurring entirely within an affiliated group and if the spin-off is not part of a plan or series of related transactions pursuant to which stock of any corporation will be distributed outside of the affiliated group. Thus, presumably the IRS will continue to rule on distributions within affiliated groups.

The second category of transactions described in the Notice is spin-offs where the distributing or controlled corporations own a small amount of Qualifying Business Assets relative to other assets. Accordingly, the Rev. Proc. provides that the IRS will not ordinarily rule on spin-offs where the Qualifying Business Assets of the distributing or controlled corporations (generally including the assets of 80-percent owned subsidiaries) constitute less than 5 percent of the total value of the corporation's assets (generally including the assets of 80-percent owned subsidiaries). Beginning in 1996, the IRS instituted a similar no-rule policy for spin-offs where the Qualifying Business Assets of the distributing or controlled corporation represented less than 5 percent of the total value of its assets, but this limitation was lifted in 2003.

The Rev. Proc. has a similar exception to the no-rule policy for this category of spin-offs as the exception described above for spin-offs that are entirely within an affiliated group. In addition, the Notice makes clear that the IRS will still consider ruling on spin-offs that fall into this category in unique and compelling circumstances. Whether such circumstances exist in a particular case will take into account all facts and circumstances, including, for example, whether a substantial portion of the non-Qualifying Business Assets would be Qualifying Business Assets but for the fact that they have not been held for five years prior to the spin-off.

The third category of spin-off transactions described in the Notice are those in which the distributing corporation or the controlled corporation elects to be a real estate investment trust ("REIT") or a regulated investment company ("RIC"). The Notice states that the IRS is generally not concerned, however, with spin-offs where the relevant corporation has been a REIT or a RIC for a substantial period of time prior to the spin-off, or where both the distributing and controlled corporations are and will continue to be REITs or RICs following the spin-off. The Rev. Proc. provides that, subject to these exceptions, the IRS will no longer issue rulings on these types of spin-offs involving REITs or RICs, except in unique and compelling circumstances.

In addition to warning taxpayers that the IRS finds these three types of spin-off transactions problematic, the Notice also lays out why the IRS believes that some of these transactions may fail to qualify for tax-free treatment under section 355. In particular, the IRS suggests that these transactions may be devices for the distribution of earnings and profits, may not have an adequate business purpose, or may not satisfy the active trade or business test. The IRS also believes that these types of spin-offs may circumvent the Code provisions intended to repeal the *General Utilities* doctrine (under which certain non-liquidating distributions could be made without incurring corporate-level tax).

Unlike many other notices the IRS has issued, the Notice does not indicate that the IRS plans to issue retroactive regulations to further address these issues. Taxpayers should nonetheless carefully consider any potential 355 distribution that is described in the Notice because the IRS is likely to scrutinize these types of transactions. Moreover, because of the no-rule policy set forth in the Rev. Proc., taxpayers must rely on an opinion of counsel instead of an IRS ruling when implementing distributions that involve the facts set forth in the Notice.

By Adam T. O'Brien, San Francisco

The Benefits and Burdens of the Proposed Section 199 Regulations

On August 26, 2015, Treasury released proposed and temporary regulations addressing an assortment of issues with respect to Code Section 199, the domestic production activities deduction (the "DPAD"). Specifically, the proposed regulations provide guidance with respect to 11 discrete issues, including: (1) contract manufacturing; (2) oil-related qualified production activities income ("QPAI"); and (3) whether "minor assembly" amounts to the manufacture, production, growth or extraction ("MPGE") of qualifying property. Additionally, the temporary regulations provide guidance with respect to calculating the DPAD's W-2 wage limitation for short tax years, an issue for which tax practitioners have sought clarity since Congress enacted section 199 in 2004.

Beginning with the proposed regulations, perhaps the most notable of the changes relates to how Treasury views contract manufacturing relationships through the lens of section 199. Under Treas. Reg. § 1.199-3(f)(1), only that taxpayer with the "benefits and burdens" of ownership over qualifying property is entitled to the deduction, a fact-intensive, hotly debated "facts and circumstances" test. Since 2004, taxpayers and the IRS have sparred over which party is entitled to the section 199 deduction: the principal owner of the property who takes on commercial risk and may create and control the relevant product specifications, or the contract manufacturer performing the physical MPGE activities.

The "benefits and burdens" test has been a source of significant controversy, leading to two recent IRS directives that each sought to refine the "facts and circumstances" test, and alternatively provided a safe harbor for taxpayers and contract manufacturers who agreed which party could take the deduction. *See* IRS LB&I Directive 04-0112-01 (February 1, 2012), superseded by IRS LB&I Directive 04-1013-008 (October 29, 2013). In 2013, the Tax Court adopted a nine factor benefits and burdens analysis for section 199 that included: (1) whether legal title to the qualifying property passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired; (4) whether the contract creates an obligation on the seller to execute and deliver a deed and an obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser and which party has control of the property or process; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage; (8) which party receives the profits; and (9) did the taxpayer actively and extensively participate in management and operations of the MPGE activity. *See ADVO, Inc. v. Commissioner*, 141 T.C. 298 (2013).

After years of the IRS seeking to place more rigor in the analysis, the proposed regulations eliminate the "benefits and burdens" test. Instead, the proposed regulations provide that in all cases only the contract manufacturer performing the physical MPGE activity in the US is entitled to the deduction. By eliminating the benefits and burdens test, the proposed regulations appear to disregard certain hallmarks of economic ownership. Under the proposed regulations, the contract manufacturer is the only party entitled to the DPAD, though the principal owner may believe it assumes all commercial risk, provides all product specifications, and actively oversees the manufacturing process. The proposed regulations also do not account for the principal owner's investment in US resources to design qualifying property, which is precisely what the DPAD is meant to encourage. Finally, this may be viewed by some taxpayers to create an inequitable result when both parties to the arrangement are US companies. Had the principal owner outsourced the physical manufacturing to a non-US third party, the principal owner would be eligible for a section 199 deduction with respect to its design efforts. By keeping the physical manufacturing in the United States, the principal owner may find itself foregoing a deduction meant to encourage domestic activity. Thus, in the eyes of principal owners, the proposed regulations may discourage the use of domestic contract manufacturers, which certainly was not the intent of Congress in enacting section 199.

The next notable issue addressed by the proposed regulations is the scope of QPAI as it relates to the oil and gas industry, including incorporating section 199(d)(9), which Congress added in the Energy Improvement and Extension Act of 2008. Specifically, the proposed regulations limit the meaning of oil-related domestic production gross receipts ("DPGR") to receipts derived from the "production, refining, or processing of oil, gas, or other similar primary products." The proposed regulations further provide that, unless an exception applies for embedded services or de minimis amounts, oil-related DPGR does not include receipts derived from the "transportation or distribution of oil, gas, or any primary product." "Transportation or distribution," without further definition, carries the risk of the IRS viewing these items expansively. The proposed regulations account for "oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands." Finally, the proposed regulations provide that a taxpayer must allocate costs to oil-related DPGR in arriving at QPAI in the same manner as other taxpayers allocate costs to non oil-related DPGR under three methods.

The third notable issue addressed in the proposed regulations concerns the scope of "minor assembly" in direct response to *United States v. Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013). In *Dean*, the Court held that the taxpayer's activity in designing and preparing gift baskets was MPGE activity for purposes of section 199. The proposed regulations include an example that provides that the preparation of gift baskets from products purchased from unrelated parties is merely a "minor assembly" activity and thus is not MPGE activity under Treas. Reg. § 1.199-3(e)(2). On September 24, 2015, the Northern District of Illinois decided a similar case in favor of the taxpayer in *Precision Dose Inc. v. United States*, No. 3:12-cv-50180 (N.D. Ill. 2015). In *Precision Dose*, the Court held that the taxpayer's activities of buying drugs in bulk and reselling them in "unit doses" was analogous to the designing and packaging activity in *Dean*, and thus eligible for the DPAD. These examples alone do not draw a clean line between MPGE activities and "minor assembly." Recognizing this ongoing issue, Treasury requested comments on how the term "minor assembly" should be defined in the regulations.

Finally, the temporary regulations effective as of August 27, 2015, provide guidance with respect to calculating the DPAD's W-2 wage limitation for short tax years. Generally, section 199(b)(1) limits a taxpayer's DPAD to 50% of the W-2 wages the taxpayer paid with respect to the MPGE activity in the taxable year. Under current Treas. Reg. § 1.199-3(e)(2), a midyear disposition of a trade or business requires the taxpayer to allocate W-2 wages during the "calendar year" between employment activities for the successor and predecessor taxpayers. The temporary regulations' preamble provides that Treasury sought to address circumstances where it is uncertain whether the employment activities were for the successor or predecessor taxpayer, and further clarify that a short year does not need to include December 31. Under the temporary regulations, the taxpayer would have to allocate W-2 wages between short years based on the time period before or after the disposition. In creating a bright-line rule, the temporary regulations bring clarity to an issue that was previously a source of controversy.

The proposed regulations do not address computer software. In their joint 2014-2015 Priority Guidance Plan, IRS and Treasury listed section 199 regulations relating to computer software as a prioritized tax accounting project. It is our understanding that the section 199 computer software regulations remain in process at Treasury.

The IRS requested comments with respect to all aspects of the proposed regulations by November 25, and scheduled a public hearing for December 10, 2015. As the Tax Court recently discussed in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015), Treasury cannot disregard the facts and evidence in the administrative record, such as notice and comment, when promulgating its regulations. For more information about *Altera* and the Administrative Procedure Act, please see prior *Tax News and Developments* article, *Tax Court Invalidates Treasury Regulation in Altera* (Vol. XV, Issue 4, August 2015) by Duane Webber, Joseph Judkins, and Kristyn Judkins, and available under publications at www.bakermckenzie.com. The authors expect the proposed section 199 regulations to face significant scrutiny, especially with respect to the proposed rules governing contract manufacturing arrangements. Notice and comment by interested parties is critical to the rulemaking process under the Administrative Procedure Act.

By Kristen Bauer Proschold, Houston and Jonathan Welbel, Chicago

Tax Court Case *R.V.I. Guaranty*: Risks are not Inherently Insurance or Investment Risks

Qualification of a transaction as an insurance policy rather than some other type of financial arrangement can result in different tax consequences. Suppose, for example, that a company wants to protect itself from the risk of default on a debt obligation acquired in its business. It could purchase insurance that transfers the risk to the insurer and secure a current deduction for the premium. Alternatively, it could protect itself from the defined peril by purchasing an option to sell the obligation to the writer of the option (a put) for a pre-determined price in the event of default. In that case, the company would reduce by the amount of the put premium its amount realized from the sale of the obligation or secure a loss deduction in the amount of the put premium if and when it allowed the put to lapse unexercised. Differential tax treatment may also apply to the person that assumes the risk. Favorable rules under Subchapter L of the Internal Revenue Code for the computation of taxable income apply to an insurance company, defined by section 816 as “any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.” A company more than half the business of which consisted of writing puts or other derivative contracts would not qualify as an insurance company.

Otherwise prodigal in their use of defined terms, the Code and regulations do not even suggest the characteristics of the financial arrangement commonly known as “insurance” and instead have left the definitional task to the courts and to the authors of rulings issued by the IRS. In their holdings so far, the courts and the IRS have sometimes touched on, but largely danced around, the issue of whether certain risks are inherently insurance risks or investment risks or whether, as in the case of the risk of default on a debt obligation, a risk can, depending upon how the transaction is structured, serve as either.

Now the issue has finally been joined. In *R.V.I. Guaranty Co., Ltd. v. Commissioner*, 145 T.C. No. 9, decided September 21, 2015, the IRS pressed the argument that the risk that the residual value of depreciable property would fall below an anticipated level constituted an inherently uninsurable investment risk. In a potentially landmark decision, the Tax Court roundly rejected this position.

The importance of the Court's decision lies not so much in its treatment of residual value insurance itself but rather in its mode of analysis. Effectively, the Tax Court appears to have rejected the position that certain risks are *per se* uninsurable. As long as a risk can be transferred and pooled in the way that risks have historically been transferred and pooled in insurance arrangements, as long as the cost of protection can be priced in the way insurance premiums have historically been priced, and as long as State regulators and consumers view the protection as insurance, there is no reason why the tax treatment accorded to insurance policies cannot apply.

The Case

R.V.I. Guaranty Co. was a Bermudan regulated insurance company and the parent of a group of corporations that includes R.V.I. America Insurance Company ("RVIA"), a Connecticut insurance company. During the years at issue, RVIA exclusively issued policies of residual value insurance to unrelated insureds, the subject risks of which R.V.I. Guaranty Co. reinsured.

Persons who lease or finance economically depreciable assets typically take out residual value insurance policies. RVIA issued such policies to lessors of passenger vehicles, commercial real estate, and commercial equipment such as aircraft and rail cars. At the inception of a lease, the lessor generally expects that the value of a depreciable leased asset will, as a result of wear and tear and other factors, decline during the term to a certain "residual value." A lessor procures residual value insurance to protect itself from the peril that the asset's depreciation will, because of excessive wear and tear or, recession, high interest rates, price deflation, or other macroeconomic factors, turn out to be more rapid than expected. Each residual value insurance policy written by RVIA indemnified the insured against the economic loss that would ensue if the asset had an actual value at the end of the lease less than the insured value specified in the policy, usually set slightly below the expected residual value.

Having elected its status as a domestic corporation under Code Section 953(d), R.V.I. Guaranty Co. calculated its taxable income under the rules set forth in Section 832. Claiming that the residual value insurance contracts did not constitute insurance for federal income tax purposes, the IRS denied the taxpayer the use of these rules.

The Economics of Insurance Risk

The case law sets out four requirements for a contract of insurance: (1) the policy's subject risk must be shifted from the insured to the insurer, (2) the risk must be distributed via pooling with other risks, (3) the transaction must constitute insurance "in its commonly accepted sense," and (4) the risk transferred must be an “insurance risk.” Although the case law and rulings provide extensive guidance with respect to the first three requirements—and R.V.I. duly applied that guidance—until now there has been very little explicit guidance with respect to the last requirement.

The key point about this case is this: The so-called “law of large numbers,” historically the conceptual underpinning of the risk distribution requirement, also distinguishes tax-favored “insurance risks” from other risks. As explained by the Court in an earlier case, *Sears, Roebuck & Co. v. Commissioner*, 96 T.C. 61, 101 (1991), aff'd in part, rev'd in part, 972 F.2d 858 (7th Cir. 1992),

> Insurers generally seek to “pool” risks from varying events causing losses to insureds. Insurance losses in a relative sense become more predictable as the size of the pool of risks grows. As more risk exposures are assumed by the pool, the average losses experienced by the pool become more tightly distributed around the expected loss. The difference between actual losses and expected losses decreases as a percentage of expected loss or in relationship to the resources of the pool. . . .The “law of large numbers” recognizes that the expected value of the average loss per policy can be more accurately predicted, assuming independent exposure units, as the size of the insurance pool increases. . .

Thus, the law of large numbers facilitates the estimation of the probability and amount of loss in a pool of risks. R.V.I. is the first judicial decision recognizing that the law not only justifies the requirement of risk distribution, as previously understood by such cases as *Sears*, but also distinguishes insurance risks from other risks. That is, a risk that lends itself to the application of the law of large numbers in the pricing of protection from the associated peril can be an insurance risk and can become the subject of transactions governed by the favorable insurance tax rules.

In perhaps the most critical passage in the opinion, the Court observed:

> In the instant case, the RVI policies clearly involved, from the insurer's perspective, an “insurance risk” rather than a financial risk of the sort assumed by a bank. As Professor Angelina explained, RVIA was at risk for “significant underwriting losses that were not related to [its] investment returns.” Depending upon the occurrence of fortuitous events, RVIA's loss under a contract could vary from zero to the full insured value. *Because the premium it charged was rarely more than 4% of the insured value, it was clearly exposed to underwriting risk, namely, the risk that the premiums charged would not be enough to cover claims paid. . . . Petitioner's business model depended not simply on its investment returns, but on the ability of its underwriters to price adequately the residual value risks borne by its insureds in order to derive a sufficient pool of premiums to cover the aggregate insured losses. This is the same pricing risk assumed by insurance companies generally.* [emphasis added].

Thus, if the purported insurer has a reasonable chance of covering any loss eventuating from the risk through the investment of the premium paid for protection from the loss, the risk is likely an investment risk, even if the defined peril is death or property damage resulting from a catastrophe, risks commonly covered by insurance. If, on the other hand, the purported insurer must, in order to cover the loss, pool the risk with other risks and determine the premiums for all the risks through the application of the law of large numbers, the risk is likely an insurance risk, even if the peril is the decline in value of an asset below a certain level, an economic loss which could also be hedged against through an option or other derivative.

In contesting R.V.I. Guaranty Co.'s position, the IRS sought, as discussed below, to impose other criteria, categorically dismissed by the Tax Court, for the identification of an insurance risk. Yet the US Supreme Court and, ironically, the IRS itself had both previously implied the overriding importance of risk pooling in distinguishing an insurance risk from an investment risk.

In *Helvering v. Le Gierse*, 312 U.S. 531 (1941), the insured, Cecile Le Gierse, wished to avoid erosion of the value of her estate due to the 60 percent maximum Federal estate tax in effect in 1935. She was aware that the estate tax provided a $40,000 exemption for life insurance receivables, but because a sufficiently large pool of healthy 80 year-olds did not exist, Cecile was uninsurable. Thus, protection priced based on the law of large numbers, the type of protection covering an insurance risk and the type of protection typically written against the peril of death, was unavailable.

Cecile then became aware of and purchased a combination life insurance and annuity product that functioned like an investment. The life insurance policy required a one-time premium of $22,946 and paid a death benefit of $25,000. The company from which she purchased the policy required her at the same time to purchase an annuity of $590 per year for life in exchange for a one-time premium of $4,179. Since her total premium was $27,125, Cecile would lose money if she died before receiving, in the form of annuities, the $2,125 excess of the premiums over her death benefit. The longer she lived after that point (roughly three years after entering into the contracts), the more of a return she would derive. Effectively, Cecile had purchased an investment with a return based on time.

Under these facts, the Supreme Court found that the insurance company had taken on an investment risk:

> Here the total consideration was prepaid and exceeded the face value of the "insurance" policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent [the insured] as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above.

According to the Court, the key point was that the prepaid consideration exceeded the death benefit. If Cecile had died the day after paying the premiums (or any time within the following several years), her estate would have been in a worse position than if she had not entered into the arrangements at all. Thus, she had not transferred the risk of her death to the insurance company.

Instead, Cecile and the insurance company had both made investments, the returns on which would tend to vary inversely with each other. The variable was Cecile's longevity. The longer Cecile lived, the more of a return she and her estate would derive from the annuities. From the insurance company's perspective, the longer Cecile lived, the greater its investment costs, in the form of annuity payments, that it would incur in investing the premiums prepaid by her.

The Court thus concluded that: “Considered together, the contracts wholly fail to spell out any element of insurance risk,” and accordingly, the Court denied the estate tax exemption.

In Revenue Ruling 89-96, as a result of a catastrophe, Y incurred a liability to injured persons that was expected to substantially exceed $130x but the exact amount of which was unknown. Y had existing liability insurance coverage of $30x and, for a premium of $50x, obtained from Z additional “liability insurance” equal to the lesser of $100x or those sums in excess of $30x for which Y would have thereafter become legally liable to pay damages as a result of the catastrophe. Because the peril had already occurred, the only question was whether Z’s investment of the $50x premium would suffice to satisfy its obligation under the contract. The ruling states that it was reasonable to expect that the premium, Z’s tax savings from treating the arrangement as insurance, and its investment income on the premium and savings would have exceeded its maximum liability to Y of $100x. The IRS thus treated as investment risks Z’s risks in the arrangement, viz., the risk that it would have had to have paid amounts to Y earlier than expected and the risk that its investment return on the premiums and tax savings would have been lower than expected.

In Revenue Ruling 2007-47 the IRS similarly treated an insurance contract protecting the insured against excessive liability for environmental damage that was certain to occur as an investment contract on the grounds that, in the IRS’s view, the purported insurer’s only risk was that the invested premium of $150x would not grow to fund its maximum liability of $300x. As in *Le Gierse* and Revenue Ruling 89-96, but unlike in *R.V.I.*, the size of the premium relative to the anticipated payout was such that investment returns alone might well fund the purported insurer’s liability. Even though environmental damage is a classic risk covered by insurance policies, the insurance company’s risk, according to the IRS, was, because of the economic arrangement, “akin to . . . timing and investment risks.”

In none of these authorities, therefore, had the Supreme Court or the IRS even suggested that certain risks *per se* could not be insurance risks. Rather, they had concluded that, instead of assuming an insurance risk from the purported insured and pooling it, the ostensible insurer merely undertook an investment risk and secured an opportunity for gain that had been opposed to the insured’s risk and opportunity for gain.

Rejected Criteria

Despite this history, the IRS has from time to time (as in *R.V.I.* itself) insisted that there is more to insurance risk than the feasibility of actuarial pricing. For example, in Chief Counsel Advice 201511021 (March 13, 2015), the IRS determined that policies that protected the insureds from loss of earnings resulting from fluctuations in the value of specified foreign currencies in which its purchases and sales were denominated had not involved an insurance risk. The IRS found that the risk was instead the business or investment risk that the taxpayer would not have made a profit on the sale of goods and services. The Advice relied heavily on the availability of derivative options to mitigate the same risk.

Although the Tax Court, in *R.V.I.*, mentioned the Advice in its opinion, it declined to express an explicit view about the IRS's conclusion. Notably, however, the Court rejected the Advice's position that the availability of non-insurance products for protecting against a risk renders the risk transferred under a policy that satisfies the other requirements of insurance an investment risk. The IRS had argued that R.V.I. Guaranty Co.'s insureds could have been analogized to investors that had purchased put options to protect the value of their stock. The Court rejected this analogy for two reasons. First, the Court noted, the insured assets were not investment assets. Although a lessor expected to generate a profit from the lease, it anticipated that the leased asset would inevitably decline in value. More important, state courts had long concluded that a product could qualify as insurance even though competing products serving the same function did not. "When it comes to mitigating risk," according to the Court, "there may be more than one way to skin the cat. The existence of other strategies does not mean that the strategy chosen is not 'insurance' or that product purchased involves no 'insurance risk'."

The IRS had also argued that the concept of "pure risk" could serve to differentiate insurance risk from investment risk. A "pure risk" is a risk that is not paired with an opportunity for corresponding gain. Because the lessor of depreciable property could profit from the lease, the risk of excessive depreciation was not, according to the IRS, a "pure risk" but instead a speculative, market, or investment risk. In rejecting this argument, the Court noted that, among other types of long recognized insurance products, municipal bond insurance did not protect against a "pure risk" as understood by the IRS: The insured bondholder could realize from the bond a gain instead of a loss covered by insurance. Although most insurance policies protect the insured from a loss associated with a "pure risk," many do not.

Finally, the IRS argued that residual value risk was not an insurance risk because the policy did not require a "fortuitous event," described by the IRS as a single, instantaneous, and identifiable event, to result in a loss from which the policy would protect the insured. (In Chief Counsel Advice 201511021 the IRS had intimated that the risk of lost profits arising from exchange rate fluctuations over a period of time was not an insurance risk for the same reason.) Unlike mortgage guaranty insurance, for example, where a fortuitous event (as understood the by the IRS), the homeowner's default, triggers the insurer's obligation to compensate the insured, a gradual decline in property value triggered RVIA's obligation. The Court responded that the IRS had confused the trigger of a payment obligation with the actual loss-causing event. While the homeowner's default may trigger the payment obligation in the case of mortgage guaranty insurance, a gradual decline in the value of the collateral for the mortgage caused the loss, just as, in the case of residual value insurance, the gradual decline in the residual value of the leased property *caused* the loss. Critically, the Court appears to have rejected the requirement of a single, instantaneous, and identifiable loss-triggering event as a *sine qua non* of insurance risk.

Other Factors

As indicated above, the case's most important conclusion is that there is nothing inherent about a risk that makes it *per se* an investment rather than an insurance risk. As long as a risk can be pooled and priced as insurance, it can serve as an insurance risk. The existence of alternative non-insurance products and the lack of a “pure risk” or a requirement of a “fortuitous event” to trigger a loss are irrelevant. But that does not necessarily mean that a risk that can be pooled and priced as insurance is an insurance risk. Indeed, in concluding that the residual value risk was an insurance risk, the Court observed, “Most importantly, every State in which petitioner does business recognizes these policies as involving insurance risk and regulates them as ‘insurance’.” The decision describes at great length non-tax state cases and statutes that have described or defined residual value policies and other contracts protecting against the decline in assets’ value as insurance. It also notes that RVIA’s regulators required it to prepare its financial statements in accordance with “statutory accounting principles” prescribed by the National Association of Insurance Commissioners. In determining that the residual value risk was insurance risk, the Court finally observed that the policies were designed and marketed as insurance policies.

Yet the Court’s emphasis that policy design and marketing and especially state regulation figure in the identification of an insurance risk is for two reasons ultimately not nearly as important as its conclusion about the inherent nature (or lack thereof) of insurance risk. First, consistent with prior authority, the Court looked to these same factors of marketing and state regulation in concluding that the residual value policy met one of the other requirements (in addition to the existence of risk transfer and distribution and insurance risk) of an insurance policy, viz., that the transaction constitute insurance in its commonly accepted sense. Thus, as a practical matter a taxpayer seeking to qualify an arrangement as an insurance contract should have, even before *R.V.I.*, become comfortable with the application of these factors to its case in any event. Before *R.V.I.*, however, the taxpayer might have worried that the existence of alternative non-insurance products and the lack of a “pure risk” or of a requirement of a “fortuitous event” (as understood by the IRS) to trigger a loss might have resulted in the characterization of a risk as an inherently uninsurable investment risk. The taxpayer might have been concerned notwithstanding that policy design and marketing and state regulation suggested the presence of an insurance risk. (Indeed, the IRS argued unsuccessfully in *R.V.I.* that the lack of a requirement of a “fortuitous event” to trigger a loss meant that the arrangement did not constitute insurance in its commonly accepted sense.) The case should greatly alleviate worries that the availability of alternative non-insurance products and the absence of “pure risk” and a requirement of a “fortuitous event” would jeopardize the federal income tax treatment associated with insurance.

The other reason why the Court’s observations about policy design and marketing and state regulation are less important than its conclusion about the inherent nature (or lack thereof) of insurance risk is that policy design and marketing and State regulation can and frequently do evolve. If, in contrast, the Court had agreed with the IRS that, to constitute an insurance policy, a financial arrangement required a single, instantaneous, and identifiable event to trigger a loss, many types of insurance—including some health insurance policies—could not under any circumstances qualify as insurance for federal income tax purposes.

Significance for Taxpayers

Although *R.V.I.* did not involve captive insurance companies, there appears to be no reason why the analysis set forth by the Tax Court in this case would not apply to policies written by such entities. The case may therefore give taxpayers, including captives, more scope to insure against a wider range of risks, as long as the insurance company issuing the policy can measure and price the risk on the basis of the law of large numbers and as long as the other requirements discussed above are met.

By Peter M. Daub, Angela J. Walitt, and Katie M.B. Marcusse, Washington, DC

IRS Attempts to Shut the Door on Controversial Option Deduction Issue with Proposed Revisions to "Next Day Rule" Regulation

On March 5, 2015, Treasury and IRS published long-awaited proposed regulations amending Treasury Regulation Section 1.1502-76 (the "Proposed Regulations") in part to clarify the timing of stock option deductions in the acquisition context. (For a general discussion of certain issues addressed in the Proposed Regulations, see prior *Tax News and Developments* article *IRS Releases Proposed Regulations on More Narrowly Tailored "Next Day Rule"* (Volume XV-2, Issue 2, April 2015) located under publications at www.bakermckenzie.com). The Proposed Regulations are the first guidance in this area since GLAM 2012-010. (For a detailed discussion of the issues addressed in the GLAM, see prior *Tax News and Developments* article *Deducting Stock Options Cashed Out on a Change in Control: The IRS Announces its View* (Volume XIII, Issue 3, June 2013) located under publications at www.bakermckenzie.com).

Anne G. Batter (Washington DC) and Kai R. Kramer (Houston) discuss the Proposed Regulations in *IRS Attempts to Shut the Door on Controversial Option Deduction Issue With Proposed Revisions to "Next Day Rule" Regulation*, which appeared in the September/October edition of the *Journal of Corporate Taxation* and also is available under publications at www.bakermckenzie.com. The article describes the changes in the Proposed Regulations as applied to stock option cash outs and other compensation events that occur in an acquisition, including a discussion of the intersection of the consolidated return rules, the all events and economic substances tests, and special deduction timing rules applicable to compensation. While the Proposed Regulations purport to clarify the rules regarding the timing of stock option deductions, because the Proposed Regulations are premised on a dubious interpretation of section 83, they serve, instead, to muddy the waters.

Analysis of Revenue Procedures Providing Guidance for Mutual Agreement and Advance Pricing Agreement Requests

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 cross-border intercompany transactions. (Rev. Proc. 2015-40 (MAP) and Rev Proc 2015-41 (APA)). Preliminary comments regarding the new guidance were provided in a prior *Tax News and Developments* article, *IRS Issues Long-Awaited Revenue Procedures Providing Guidance for Mutual Agreement Requests and Advance Pricing*

Agreement Submissions (Vol. XV, Issue 4, August 2015) located under publications at www.bakermckenzie.com.

Barbara J. Mantegani (Washington, DC) and Liz Yablonicky (Chicago) discuss the new guidance in more detail in two articles which appear in the October 1 and October 15 editions of the Bloomberg BNA Tax Management Transfer Pricing Report, *Rev. Proc. 2015-41: A Needed Reboot of the IRS Advance Pricing Agreement Process* and *Rev. Proc. 2015-40: A New Approach to Treaty-Based Dispute Resolution*, both of which are also available under publications at www.bakermckenzie.com. The APA article explores the most significant changes in the new revenue procedure on APAs, including heightened information requirements from taxpayers as well as higher user fees, and offers practical suggestions for taxpayers filing new APA requests. The MAP article explores the most significant changes in the new revenue procedure on competent authority assistance, which reflects the evolution in transfer pricing that has occurred worldwide in the last decade, particularly developments under the OECD's project on base erosion and profit shifting (BEPS).

China Transfer Pricing: BEPS with Chinese Characteristics?

The newly released discussion draft of Chinese transfer pricing regulation ("Draft Measures") will influence not only the multinational's PRC subsidiary but also its oversea affiliates once finalized. The PRC subsidiaries will need assistance from the US headquarters to prepare the transfer pricing documentation required by the Draft Measures, including the master file, the country-by-country report and part of the local file. Recently, China has been very active to strengthen its transfer pricing administration and PRC tax authorities have become more aggressive than ever in transfer pricing audits, with more focus on the value chain analysis, outbound related-party payments, location specific advantages (LSA) and intangibles. Therefore, US multinationals should be fully prepared to respond to the new challenges from the PRC tax authorities.

For a full discussion on these draft measures, please see previously released Global Tax Client Alert *China Transfer Pricing: BEPS with Chinese Characteristics?* distributed on September 25, 2015, and available under publications at www.bakermckenzie.com.

By Shanwu Yuan, New York

IRS Extends FATCA Dates as Information Exchange Arrangements Proceed

The US Treasury Department and the IRS extended key FATCA transitional rules in Notice 2015-66. Specifically, Notice 2015-66: (i) extends the date for beginning of withholding on gross proceeds to January 1, 2018; (ii) extends the date for beginning of withholding on foreign passthru payments to January 1, 2019 (at earliest); (iii) extends eligibility for limited branch and limited FFI status through December 31, 2016; and (iv) extends the date by which sponsoring entities need to register sponsored entities to January 1, 2017. The extensions announced in Notice 2015-66 provide relief for US withholding agents who are developing systems to handle gross proceeds withholding, among others. The Notice also provides relief and clarity for financial institutions with a presence in

Model 1 IGA jurisdictions that have not yet brought the IGA into force. Taxpayers can rely on the Notice prior to the issuance of the amended regulations. Notwithstanding the extensions outlined in Notice 2015-66, the US Treasury also announced the signing of Competent Authority Arrangements with Australia and the United Kingdom and that the US has received its first batch of exchanged information from Australia.

For a full discussion on Notice 2015-66, please see previously released Global Tax Client Alert *IRS Extends FATCA Dates as Information Exchange Arrangements Proceed* distributed on October 1, 2015, and available under publications at www.bakermckenzie.com.

IRS Issues Proposed Regs Addressing Taxation of US Citizens or Residents Receiving Gifts or Bequests from Expatriates

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act") is well-known for imposing an exit tax on US citizens and long-term green card holders who expatriate from the United States. The HEART Act also imposes a tax on US citizens or residents who receive gifts or bequests from certain expatriates. This tax on US recipients of gifts or bequests is codified in Code Section 2801 (the "section 2801 tax"). Like the exit tax, the section 2801 tax is applicable to persons who expatriate on or after June 17, 2008. Guidance regarding the section 2801 tax has been long-awaited. On September 9, 2015, the IRS issued proposed regulations addressing section 2801 (the "proposed regulations"). Section 2801 imposes a tax on US citizens and residents who receive certain gifts or bequests (known as "covered gifts" and "covered bequests"), directly or indirectly, from a so-called "covered expatriate." For purposes of section 2801, US domestic trusts as well as foreign trusts electing to be treated as US domestic trusts for purposes of section 2801 will be treated in the same manner as US citizens. Tax is paid by the recipient of the covered gift or bequest. Any tax owed under section 2801 must be reported on new IRS Form 708. US recipients must use Form 708 to report each covered gift and covered bequest received during the calendar year and to provide the information required by the proposed regulations.

For a full discussion on these draft measures, please see previously released Tax Client Alert *IRS Issues Proposed Regulations Addressing Taxation of US Citizens or Residents Receiving Gifts or Bequests from Expatriates* distributed on October 6, 2015, and available under publications at www.bakermckenzie.com.

Canadian Tax Update

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

Canadian Courts Refuse Emergency Injunction in Case Challenging the Implementation of FATCA

Both the Canadian Federal Court (2015 FC 1082) and the Federal Court of Appeal (2015 FCA 209) recently dealt what may prove to be the fatal blow to a challenge of Canada's implementation of the United States' *Foreign Account Tax Compliance Act* ("FATCA").

In *Hillis v. Canada (Attorney General)*, two representative litigants filed suit seeking a permanent injunction prohibiting information disclosure to the IRS for purposes of FATCA. The plaintiffs are dual Canadian/US citizens who have not lived in the United States since they were children. They claimed that the intergovernmental agreement that implemented the disclosure regime ("IGA") is inoperative both on constitutional grounds and because it is contrary to provisions of the existing Canada-US income tax treaty ("Treaty") and the Canadian *Income Tax Act* ("Act"). The parties put the constitutional issues on hold so that they could proceed by way of summary trial on the non-constitutional issues before September 30, 2015 – which was the deadline for transmission of taxpayer information to the IRS for 2014.

At trial, the plaintiffs argued that the IGA is inconsistent with:

i) the Treaty's article XXVI-A assistance in collection provision (which prohibits assistance for periods during which the plaintiffs were Canadian citizens);

ii) article XXVII's information exchange obligation (on the basis that most of the information to be exchanged under the IGA fails the "may be relevant for carrying out the provisions of [the tax laws]" requirement because most US persons resident in Canada do not owe taxes to the US);

iii) article XXV's prohibition on subjecting US nationals in Canada to requirements more burdensome than those applied to Canadian nationals in the same circumstances (on the basis that information about Canadian nationals who are not US persons would not be disclosed to the IRS); and

iv) the Act's section 241 prohibition on the disclosure of confidential taxpayer information (on the basis that the relevant statutory exception allows disclosure for purposes of a tax treaty, and the IGA is not a treaty per se).

While appreciating that affected Canadian taxpayers may find the consequences flowing from disclosure under the IGA to be deplorable, the trial judge dismissed each of the plaintiffs' arguments. He concluded that the evidence did not demonstrate that automatic information exchange is tantamount to helping the IRS collect taxes yet to be assessed, and that article XXVII does not actually prohibit information exchange that is authorized elsewhere (*e.g.* under the IGA). Further, rather than placing additional requirements on US nationals, the burden of complying with the IGA is placed on financial institutions and is equally applicable to Canadian nationals in the United States. As a result, article XXV is of little consequence in this case. Finally, the judge concluded that section 241 does not prohibit the form of disclosure at issue because the IGA is a tax treaty for Canadian purposes, irrespective of whether the United States considers the agreement in the same fashion.

The plaintiffs promptly appealed the Federal Court order and moved for an emergency injunction so that their appeal would not be rendered moot by the anticipated September 30th transmission to the IRS. The Federal Court of

Appeal readily denied the plaintiffs' motion. To add insult to injury, that result was based largely on the fact that, as indicated in the Crown's responding submissions, there was no information *about these particular taxpayers* that would actually be transmitted to the IRS on September 30th, which meant that the plaintiffs would not be irreparably harmed if the Court denied the injunction. One wonders whether a different set of test litigants would have had better luck. However, it is notable that a preliminary injunction was refused by the US District Court for the Southern District of Ohio in a similar challenge south of the border the day before the Canadian appeal court decided the issue: *Crawford et al. v. United States Department of the Treasury, et al*., Case No. 3:15-cv-250 (29 September 2015).

Stepping back, this failed court challenge means that the IGA remains in force and that the Canada Revenue Agency ("CRA") likely transmitted a large volume of information to the IRS by the September 30th deadline. (According to testimony heard by the Federal Court, there are between 750,000 and 2,000,000 US persons currently present in Canada who would be affected by the IGA.) However, as the Federal Court noted, the additional reporting burden created by the IGA falls primarily on Canadian financial institutions and Canadian branches of foreign financial institutions, which face a 30% withholding tax on US-source income and the sale of US-source investments if they fail to comply with FATCA. That said, before the Canadian courts weighed in on the matter, those same institutions faced potential breaches of other Canadian statutes, privacy laws, and client confidentiality rules for complying with the IGA. As a result, although *Hillis* may not be great news for US persons in Canada, financial institutions should breathe a small sigh of relief…at least until the appeal or the related constitutional issues are decided down the road.

Retroactive Transfer Price Adjustments - Additional Canadian Customs Guidance

On September 17, 2015, the Canada Border Services Agency ("CBSA") released a revised Customs D-Memorandum D13-4-5, "Transaction Value Method for Related Persons" (the "Memorandum") (see CBSA, online: http://www.cbsa-asfc.gc.ca/publications/dm-md/d13/d13-4-5-eng.html). The Memorandum provides additional information regarding the change in the CBSA's policy regarding retroactive transfer price adjustments that was announced in Customs Notice 15-001 published January 19, 2015 (see CBSA, online: http://www.cbsa-asfc.gc.ca/publications/cn-ad/cn15-001-eng.html). Historically, the CBSA took the position that importers could not claim duty refunds as a result of downward retroactive price adjustments, nor did importers have to correct the value for duty originally declared to account for downward price adjustments where the goods were imported on a duty free basis. With the publication of Customs Notice 15-001 the CBSA changed it policy. However, importers have always had to correct the value for duty declared to account for retroactive transfer price increases, regardless of whether additional duty was payable. This change in policy introduced significant new opportunities, and responsibilities, for importers involved in cross-border trade with related entities.

Transaction value is the most common valuation method applied to imports into Canada, and is essentially the price paid or payable for the imported goods, subject to certain adjustments. The transaction value method can only be used to value goods sold between related persons, if the price paid or payable is "uninfluenced." Consistent with the CBSA's past policy, the Memorandum states that where a transfer price agreement (“TPA”) exists in writing, is in effect at the time of importation (that is, the vendor and importer have determined the price paid or payable in accordance with the TPA), and follows one of the methods set out in the OECD transfer pricing guidelines, the CBSA considers the transfer price to be the uninfluenced price paid or payable for the imported goods. However, for the price to remain uninfluenced, any payments made or adjustments to the price after importation must be declared to the CBSA. A correcting declaration is now mandatory following all upward price adjustments and following a downward price adjustment if the correction would be revenue neutral. Moreover, where the imported goods are subject to duties and the price paid for the imported goods is reduced, the importer may, at its option, file a refund claim.

The CBSA also notes in the Memorandum that the process for establishing an uninfluenced related party price may be reflected, not only in a TPA, but also in a study, report or an advance pricing arrangement. An importer may rely on these written agreements to establish a transfer price as the basis of the price paid or payable for the imported goods even when the agreement is not signed at the time of importation, provided that the importer can demonstrate that the agreement existed and was in effect at the time of importation, and that the value for duty was based on that agreement.

Finally, the CBSA has confirmed that once the total net adjustment is determined for a given fiscal year, an importer will be seen to have “reason to believe” a correction is required. For example, if there are periodic transfer price adjustments made at the end of each quarter, and the final transfer price adjustment is not known until the last and final adjustment is made, the importer will not have reason to believe the values declared are incorrect and require correction until the last transfer price adjustment is made for the period and the total net amount is known. Under the Customs Act, a correction must be made within 90 days following the date an importer had reason to believe that the original declared value was incorrect. In circumstances where an importer does not make a correction within the 90-day timeframe, a voluntary disclosure to the CBSA may be available to assist in mitigating liability.

As a result of this new policy, on a going forward basis, importers should implement policies and procedures to ensure the timely submission of mandatory correcting entries and to take advantage, where available, of optional duty refunds. In addition, importers who have imported dutiable goods that have been subject to retroactive price reductions have the ability to file refund claims back for a four-year period from the date the refund claim is filed. Consequently, this change in CBSA policy can result in significant refund claims for importers.

Great-West Decision Brings Some Goods to Financial Service Providers

The Canadian goods and services tax/harmonized sales tax (“GST/HST”) is a value added tax that generally must be collected by a person making a taxable supply of property or services. A person that makes taxable supplies can generally recover the GST/HST that it pays on its purchases through the input tax credit mechanism. Certain services are “exempt” supplies for GST/HST purposes. A person making an exempt supply is not required to collect GST/HST. However, a person making exempt supplies is generally not entitled to claim input tax credits to recover the GST/HST that it pays on purchases.

Financial services are generally considered to be exempt supplies for GST/HST purposes. As a result, GST/HST is an unrecoverable cost to a person who provides a financial service. Accordingly, a financial institution, such as an insurance company, would generally prefer that supplies that are made to it are characterized as exempt financial services (on which no unrecoverable GST/HST would be payable) and not as taxable services (on which unrecoverable GST/HST would be payable).

The characterization of supplies made to a financial institution was recently addressed by the Tax Court of Canada in *Great-West Life Assurance Co*. v. *R*., 2015 TCC 225. The services under consideration in *Great-West* were automated claims processing and related services provided to an insurance company in connection with a prescription drug group benefit plan. These services allowed a member of a group benefit plan to have his or her insurance claim processed at the pharmacy such that it was unnecessary for the plan member to submit a claim and then wait for payment by the insurance company. The CRA argued that the automated claims processing services were taxable services, whereas Great-West argued that the services were exempt financial services.

The definition of "financial service" in the Excise Tax Act (Canada) is complex. In simple terms, a particular service will qualify as a financial service if it falls under one of the inclusions in the definition and is not carved out by one of the exclusions. The definition was amended following a 2009 Federal Court of Appeal decision (*Canadian Medical Protective Assn*. *v*. *R*., [2009] G.S.T.C. 65) in which the Court ruled against the CRA's restrictive interpretation. The amendments introduced additional exclusions to the definition of "financial service," including one for services preparatory to or provided in conjunction with a financial service (e.g., a service of collecting, collating or providing information). Following these amendments, there were concerns in the financial services community that the new exclusions would unduly narrow the range of services that could qualify as a "financial service."

Although the Court found in *Great-West* that the services in question were not financial services (on the basis that the services were "prescribed services"), there was some good news for the financial services industry. Specifically, the Court indicated that the key factor in determining whether a particular service is a "financial service" is the service's "essential character," thereby limiting the application of the exclusion referred to above in respect of services that are preparatory or provided in conjunction with another service and increasing the scope of services that should be considered financial services.

Great-West may have expanded the scope of financial services such that services that were formerly considered to be taxable services may now be financial services. Following the *Great-West* decision, a financial institution and its suppliers should revisit whether services provided by the suppliers to the financial institution are financial services.

By Paul D. Burns, Alex Pankratz, Randall Schwartz, Erica Lindberg, Mark Tonkovich, and Andrew Chien (Articling Student), Toronto

New York State Addresses the Estate Tax Treatment of Single Member LLC Interest

New York State addressed the estate tax treatment of an interest in a single member LLC in an advisory opinion dated May 29, 2015. Non-residents of New York investing in New York property through disregarded entities should consider the implications of the reasoning in the advisory opinion for their New York investments.

The advisory opinion, issued by the Department of Taxation and Finance's Office of Counsel, concluded that a membership interest in a single member LLC owning New York real estate is not treated as intangible property for New York estate tax purposes where the single member LLC is disregarded for income tax purposes. The ruling involved a taxpayer residing in New York State who was considering forming a single member Delaware LLC to hold a New York condominium. The petitioner then planned to move outside of New York State. The single member LLC would have been disregarded for income tax purposes, as the taxpayer was the sole owner and the LLC did not plan to file an election to be treated as a corporation.

New York State estate tax applies to transfers by non-resident decedents of New York real estate and tangible personal property located in New York State. Where a non-resident holds an interest in a corporation, partnership, or trust, that interest is considered intangible property and may not be subject to New York State estate tax even if the corporation, partnership, or trust owns New York real estate, subject to certain qualifications discussed below. The Office of Counsel reasoned that because a single member LLC not electing to be classified as a corporation is disregarded as an entity for income tax purposes, such an LLC should also be disregarded for New York State estate tax purposes. Accordingly, the advisory opinion concluded that the single member of the LLC would be treated as holding the New York real estate directly for New York State estate tax purposes. An advisory opinion is binding on the Department of Taxation and Finance only as to the person to whom the letter is issued.

The reasoning in the advisory opinion regarding an LLC that has not elected to be treated as a corporation is inconsistent with the reasoning of the US Tax Court in the *Pierre* case. (*See Pierre v. Comm'r*, 133 TC 2 (2009).) In *Pierre*, the Tax Court held that the taxpayer's transfer of her interest in a disregarded single member New York LLC was a transfer of the LLC interest rather than the underlying assets of the LLC. In reaching its holding, the Tax Court referred to a New York State law under which a membership interest in an LLC is personal property. N.Y. Ltd. Liab. Co. Law sec. 601. Thus, the reasoning of the advisory opinion appears to be inconsistent with both the *Pierre* case and New York Limited Liability Company Law.

The advisory opinion does state that where real property, including a condominium, is held by a corporation, partnership or trust, the interest in such an entity has been held to constitute intangible property under case law. However, when New York real property is held by a non-resident through a corporation, it is also important to keep an October 24, 2008, New York advisory opinion in mind. Under this advisory opinion an interest in an S corporation (and presumably a C corporation) that owns New York real property is considered an intangible asset and is not included in a non-resident decedent’s gross estate, unless the corporation is not entitled to recognition under a 1943 US Supreme

Court case. This case held that a corporation's separate existence must be recognized for tax purposes so long as its purpose is the equivalent of business activity. Therefore, if a non-resident decedent owns his or her New York real property through a corporation, uses it for personal purposes, and does not regularly rent it to third parties, the property is not necessarily sheltered from New York estate tax.

It would be preferable for the real property to be held through a partnership since the 1943 case and the 2008 advisory opinion do not address partnerships, although it is possible that the 1943 decision could be extended to a partnership. In the end, the non-resident taxpayer can be no worse off holding his or her New York real property through a partnership, although he or she must keep in mind that it is possible the interest will still be subject to New York estate tax if the partnership does not have a business purpose.

Non-residents of New York investing in New York property through disregarded entities should consider the implications of the reasoning in the May 29, 2015 advisory opinion, as well as the October 24, 2008 advisory opinion, for their New York investments. The analysis of their reasoning in a particular case should involve examining their applicability in light of *Pierre* and considering alternative structures.

By Glenn G. Fox and Paul F. DePasquale, New York

Taxing the Cloud: Chicago Expands the Scope of its Personal Property Lease Transaction Tax

On June 9, 2015, the City of Chicago ("Chicago" or the "City") issued a new tax ruling ("Ruling #12") in an attempt to expand the scope of the City's Personal Property Lease Transaction Tax (the "Lease Tax"). Currently, the City imposes a 9% Lease Tax on amounts paid for the use of personal property in the City, including charges paid pursuant to a "nonpossessory computer lease," unless such charges are exempt. Ruling #12 restricts the scope of transactions that might otherwise qualify for exemption by expressly subjecting to tax "cloud based" service transactions in which users access a provider's computer.

Nonpossessory Computer Leases Subject to the Lease Tax

"Nonpossessory computer leases" are defined by Chicago ordinance as "nonpossessory lease[s] in which the customer obtains access to the provider's computer and uses the computer and its software to input, modify or retrieve data or information [...]." Transactions involving the customer's use of a computer are exempt from the Lease Tax to the extent: (1) the customer's use or control of the provider's computer is *de minimis*; and (2) the charge is predominately for information transferred to the customer, rather than for the customer's use or control of the computer ("Exemption 11").

Ruling #12 restricts the scope of transactions that might otherwise qualify for exemption under Exemption 11. More specifically, Ruling #12: (1) broadens the scope of what constitutes a "customer's use or control of the provider's computer" beyond a *de minimis* level; and (2) narrows the definition of what constitutes a charge for the customer's use of obtaining proprietary information.

As a result, any transaction involving the use of a computer for anything more than the most basic search function might not qualify for exemption under Exemption 11. For example, charges to access a provider's computer server would generally not be exempt from the Lease Tax to the extent the access permits the customer to manipulate data to manage business functions or to search for information.

Incidence of the Lease Tax

Although the incidence of the Lease Tax is imposed on the customer, the provider of the taxable transaction is obligated to collect the tax. If the provider of the taxable transaction does not have nexus with Chicago--that is, no physical presence within the City--the provider would not be required to collect and remit Chicago tax on charges to its customers. However, the provider's Chicago-based customers would then be required to independently self-assess and remit the Lease Tax directly to the City on any taxable transactions.

Sourcing Taxable Transactions and Knowledge of Chicago Use

Sourcing each individual computer use to the physical point of access is nearly, if not completely, impossible. Ruling #12 addresses the practical challenges of sourcing to the "place of use" by adopting the rules set forth in the Illinois Mobile Telecommunications Sourcing Conformity Act (the "Illinois MTSA"). The Illinois MTSA expressly sources sales of telecommunication services to the "place of primary use." The "place of primary use" must be the residential street address or the primary business street address of the customer.

While the Illinois MTSA does not contemplate allocation of charges based on actual use, Ruling #12 sets forth additional allocation and apportionment provisions directed at sourcing charges based on customers' Chicago and non-Chicago uses.

First, Ruling #12 provides that providers should charge and collect the Lease Tax from their customers to the extent they have knowledge that any given customer's "employees or other individuals" are accessing their computers from terminals or devices located in Chicago and elsewhere. In such instances, the ruling instructs that a charge covering "both the Chicago use and the non-Chicago use should be apportioned." To that end, Ruling #12 provides that use of individual access codes, seats, licenses, etc., will be presumed to take place at each employee's/individual's principal office location.

Second, Ruling #12 provides that if the provider has information to indicate some Chicago use by a customer, but not enough on its own to perform a reasonable apportionment, the provider should collect the 9% Lease Tax from the customer "based on the assumption that all use takes place in Chicago," unless:

1. Actual or estimated Chicago usage by employees/individuals is provided by the customer; or

2. In case of a customer with 10 or more employees/individuals who are assigned access codes, seats, licenses, etc., the provider receives written confirmation that the customer is registered to pay the Lease Tax directly to the City.

As noted above, the Illinois MTSA expressly sources sales to a single location, irrespective of where the mobile telecommunication service originates, terminates, or passes through. However, Ruling #12's additional allocation provision appears to be in conflict with the Illinois MTSA's single source, place of primary use billing address test that the ruling purports to adopt.

Effective Date of Ruling #12 Postponed; Tax Rate Cuts and Amnesty Proposed

The City originally stated that it would "limit the effect of this ruling to periods on and after September 1, 2015" in order to allow affected businesses sufficient time to make required system changes. However, the Chicago business community has already pushed back on the effects of Ruling #12, and the City announced that it will extend the effective date of Ruling #12 to January 1, 2016.

Mayor Rahm Emanuel's office also stated that the City "will be taking measures to provide relief to small business so as not to put them at a competitive disadvantage." Furthermore, it has been reported that in connection with the City's 2016 budget plan, Mayor Emanuel proposed lowering the rate of the Lease Tax from 9% to 5.25% and granting amnesty for Lease Tax payments owed for years prior to 2015. How broadly these measures will be implemented, and who exactly they will apply to, has yet to be officially determined. However, as reported, it appears that the rate reduction and amnesty program will likely only apply to sales involving the rental of nonpossessory computer leases/cloud based service transactions.

By Theodore R. Bots and David Andrew Hemmings, Chicago

Multistate Tax Compact Litigation: 3-Factor Apportionment Election Update

The past few months have given rise to several developments in the ongoing taxpayer challenges for the right to use the Multistate Tax Compact's ("MTC" or the "Compact") evenly weighted, three-factor (i.e., property factor, payroll factor, and sales factor) apportionment election provision in lieu of the state's adoption of an apportionment factor that relied more heavily on the sales factor. The following summarizes recent developments in five key states (California, Michigan, Minnesota, Oregon, and Texas) with active MTC three-factor apportionment election controversies.

Each of these states had at least two laws related to the apportionment of income: one statute adopting the Compact election in some form and another statute enacting a separate state-specific apportionment rule. The MTC apportionment formula was the preferred option for many multistate taxpayers based outside of these states, because it accounted for such companies' out-of-state payroll and property factors and diminished the importance of the sales factor, as compared to the state-specific apportionment rule. In determining whether taxpayers in states that adopted the Compact have the ability to elect to use the MTC apportionment formula, some of the courts have considered the nature of an interstate compact such as the Compact and the ability of a state legislature to unilaterally amend the Compact, pursuant to limitations provided by the Contract and Compact Clauses of the US Constitution.

California – *Gillette Co. v. Franchise Tax Board*

On October 6, 2015, the California Supreme Court heard oral arguments in the much-anticipated lead MTC case, *Gillette Co. v. Franchise Tax Board*. The oral arguments occurred just over three years after the California Court of Appeal determined that corporations were permitted to elect to use the MTC's evenly-weighted, three-factor apportionment formula instead of the four-factor apportionment formula (property, payroll, and double-weighted sales) that California enacted in 1993. A decision from the California Supreme Court is anticipated around the end of this year.

For previous updates on this case, please see the previously released Client Alert *California Apportionment Options for Filing* distributed on November 20, 2012, and available under publications at www.bakermckenzie.com.

Michigan – *Gillette Commercial Operations N. Am. & Subsidiaries v. Dep't of Treasury*

The Michigan MTC election debate continued on September 30, 2015, when the Michigan Court of Appeals affirmed the Michigan Court of Claims' dismissal of 54 MTC election cases in which out-of-state taxpayers challenged the retroactive effect of Public Act 282--a 2014 law that repealed the MTC election as of January 1, 2008. In *Gillette Commercial Operations*, the consolidated taxpayers challenged the Michigan Court of Claims' dismissal on the basis that: (1) the retroactive repeal provided in Public Act 282 violates due process; (2) the Compact is binding on the Multistate Tax Commission's members and retroactive repeal violates the terms of the Compact agreement; and (3) that retroactive legislation violates principles of separation of powers. The Court of Appeals rejected each of these arguments, agreeing with the lower court that the retroactive repeal of the MTC through Public Act 282 was not an unconstitutional act and that the Compact was not a binding interstate agreement.

It is expected that the taxpayers in *Gillette Commercial Operations* will appeal the ruling to the Michigan Supreme Court. If granted, the appeal will not be the first time that the Michigan Supreme Court has addressed the MTC issue. In July 2014, the Michigan Supreme Court ruled in *IBM v. Department of Treasury* that IBM was entitled to use the MTC election on its 2008 return because it preceded the Michigan legislature's first attempt to repeal the MTC election effective in 2011. The Michigan Supreme Court then denied the Department's subsequent motion for reconsideration after Public Act 282 was passed and remanded the case to the Court of Claims for entry of an order granting summary disposition in favor of IBM. Notwithstanding the Michigan Supreme Court's denial of the Department's motion for reconsideration and order to grant summary disposition in favor of IBM, the Michigan Court of Claims instead held that the retroactive effect of Public Act 282 precluded IBM's claim. For previous updates on the Michigan MTC debate, please refer to prior *Tax News and Development* articles *Never a Dull Moment…Michigan Seeks to Re-Write History By Retroactive Repeal of the Multistate Tax Compact* (Volume XIV, Issue 5, October 2014), *Ready for Another Round? Michigan's Second Retroactive Repeal of the Multistate Tax Compact Election* (Volume XIV, Issue 6, December 2014), and *Michigan Multistate Tax Compact Update: Michigan Court of Claims Upholds the Retroactive Repeal of the Multistate Tax Compact in Yaskawa and Ingram Micro* (Volume XV, Issue 1, February 2015) available under publications at www.bakermckenzie.com.

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Minnesota – *Kimberly-Clark Corp. v. Commissioner of Revenue*

On June 19, 2015, the Minnesota Tax Court granted the Commissioner of Revenue's motion for summary judgment in Minnesota's lead Compact case, *Kimberly-Clark Corporation v. Commissioner of Revenue*. In ruling for the state, the Minnesota Tax Court paid close attention to the historical framework behind Minnesota's adoption of the Compact in 1983 and subsequent statutory amendment to eliminate the equally weighted, three-factor apportionment election in 1987.

The Minnesota Tax Court determined that the taxpayer failed to prove that the Minnesota legislature's repeal of the MTC apportionment election provision in 1987 was an unconstitutional violation of the state and federal contracts clauses. In reaching this determination, the Tax Court specifically noted that "no Compact provision contains or constitutes a separate clear and unmistakable promise that the State would not alter or repeal the election."

Kimberly-Clark's petition for appeal to the Minnesota Supreme Court was granted on August 14, 2015.

Oregon – *Health Net, Inc. v. Department of Revenue*

Another setback was recently handed to taxpayers on September 9, 2015 when the Oregon Tax Court granted the Oregon Department of Revenue's motion for summary judgment in *Health Net, Inc. v. Department of Revenue*. The Tax Court's ruling was premised, in part, on the grounds that the Compact was not a contract because it was not supported by consideration from the member states and therefore could not be a binding contract for purposes of the Contract Clause analysis.

For the 2005-2007 tax years at issue in *Health Net*, separate apportionment provisions were provided in two different Oregon statutes, one providing for apportionment using the Compact formula and another providing for apportionment using an Oregon-specific formula. Prior to 1989, the apportionment formulas in both provisions were the same evenly-weighted, three factor formula. In 1989, the Oregon legislature amended the Oregon-specific apportionment formula to double the weight accorded to the sales factor (and eventually moved to a single-sales factor by 2005); however, the legislature did not repeal the Compact formula. In 1993, the Oregon legislature enacted separate legislation to provide that if Oregon enacted a state apportionment formula that conflicted with the Compact election provision, the state's apportionment formula would be controlling.

The Oregon Tax Court determined that the Compact did not substantively limit the Oregon legislature's ability to pass legislation disabling the MTC election. In ruling for the state, the court found that the Compact was not a contract because any reciprocal promises in the Compact were "illusory," given the ability of any member state to withdraw from the Compact at any time. The court also noted that the Compact was not approved by Congress and thus was a state law, not a federal one, and subject to review as such.

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Texas – *Graphic Packaging Corp. v. Hegar*

On July 28, 2015, the Texas Court of Appeals in *Graphic Packaging Corp. v. Hegar* affirmed a summary judgment order in favor of the Texas Comptroller on the basis that the MTC election is not applicable because the Texas franchise tax is not an income tax. The Texas franchise tax is imposed on "taxable margin," which is generally determined by selecting the lesser of: (i) total revenue minus cost of goods sold; (ii) 70% of total revenue; (iii) total revenue minus $1 million; or (iv) total revenue minus specified compensation. Graphic Packaging argued that the Texas franchise tax falls within the definition of "income tax" as defined in the Compact because the franchise tax is "imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically or directly related to particular transactions."

In ruling in favor of the state, the Court of Appeals found that each of the various alternative bases for determining taxable margin did not result in "net income," and as a result the franchise tax was not a tax imposed on or measured by net income. After determining that the franchise tax was not an income tax as defined by the Compact, the court concluded that the taxpayer was not permitted to elect the MTC apportionment formula because that formula only applies to income taxes, not the Texas franchise tax. Instead, the taxpayer was required to use a single sales factor apportionment formula to apportion its taxable margin for Texas franchise tax purposes.

By David Andrew Hemmings, Chicago

Getting Better All the Time… Alexandra Minkovich Joins Baker & McKenzie's Tax Policy Practice in Washington, DC

Baker & McKenzie's North American Tax group is pleased to welcome **Alexandra Minkovich** as Counsel in Washington, DC, where she recently joined Mary Bennett, Carol Dunahoo, and Josh Odintz as a Washington member of the Firm's Global Tax Policy practice.

Ms. Minkovich most recently served as Associate Tax Legislative Counsel with the US Department of Treasury, Office of Tax Policy, where she was responsible for governmental and legislative compliance with the Administrative Procedure Act, including providing advice with respect to litigation regarding the validity of Treasury and IRS regulations. She also advised the Assistant Secretary for Tax Policy and the General Counsel on a wide spectrum of regulatory matters, including guidance on issues ranging from whistleblower provisions, civil penalties and penalty relief, disclosure of tax return information, retroactivity, and the tax implications of the Supreme Court's same-sex marriage ruling. Alexandra also advised on implementation and policy matters during the first tax filing season where taxpayers were required to report their health insurance status under the Affordable Care Act. We're pleased that she will be bringing that experience and first-hand insight to the Firm's clients with respect to any number of today's important tax policy, legislative, and regulatory issues.

Prior to Alexandra's government service, she was in private practice in New York, where she focused principally on tax issues facing the financial services and banking sector, advising on financial products, foreign tax credit generator transactions, etc. We are excited that she is bringing those skills to bear as well in service of our many clients in those important industry groups.

Alexandra is a graduate of the University of Pennsylvania and received her law degree from the Columbia University School of Law and an LL.M. in Taxation from New York University.

Baker & McKenzie's Tax Policy Group counts among its members a number of individuals who previously served in top positions on Capitol Hill, in Treasury, the IRS, the OECD, and other governmental organizations and who have had a front row seat as policies have been developed, laws have been enacted, and guidance has been written. They bring to the table the experience and contacts in all areas of government that shape global tax policy, and they are able to help the Firm's clients effectively communicate their concerns to policymakers and make sound and practical business decisions in an evolving legal environment. The group represents our clients' interests before Congress, the Treasury, and the IRS in the United States, and before the OECD, the United Nations, the European Commission, and other governments around the world. It also represents clients under investigation by legislative and other governmental committees in the United States and abroad. The group is fully integrated into all areas of our global tax practice, thereby allowing us to provide clients with seamless service and up-to-the-minute advice and counsel.

Tax News and Developments is a periodic publication of Baker & McKenzie's North American Tax Practice Group. The articles and comments contained herein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases. Past performance is not an indication of future results.

Tax News and Developments is edited by Senior Editors, James H. Barrett (Miami) and David G. Glickman (Dallas), and an editorial committee consisting of Glenn G. Fox (New York), Kirsten R. Malm (Palo Alto), Robert H. Moore (Miami), John Paek (Palo Alto), Alex Pankratz (Toronto), Patricia Anne Rexford (Chicago), Caryn L. Smith (Houston), and Angela J. Walitt (Washington, DC).

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. To be added to the North American Tax distribution list contact taxnews@bakermckenzie.com.

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