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In Memoriam - Robert F. "Bob" Hudson Jr.

Bob Hudson, the founder of the Miami office tax practice and a well respected international tax attorney, passed away on Monday, December 28, 2015 while vacationing in Paris with his wife, Edith. He was 69 years old. Bob was a passionate person who loved his work, his family and his friends. He was a larger than life character and had a great sense of humor. Stung by the travel bug, Bob and Edith loved traveling to new places on their bucket list. Bob was a significant patron of the arts and was active in community service organizations. He had served as Vice Chairman of the Performing Arts Center Foundation, Chairman of the Concert Association of Florida, Director of Camillus House, Sponsor of Educate Tomorrow, and an active participant in the United Way, Leukemia Society, Rotary Club of Miami and the Greater Miami Chamber of Commerce. He had an encyclopedic knowledge of wine and a superb palate, and was a past president of the International Wine & Food Society.

Bob was born in Miami and attended Coral Gables Senior High. In May of 2014, he chaired and celebrated his 50th high school class reunion. He earned both his J.D. and his Bachelor degrees in economics from the University of Florida, where he also taught economics courses at the College of Business Administration while attending law school. He was a major supporter of the Florida Alpha Chapter of Sigma Phi Epsilon at the University of Florida. He earned an LL.M. in Taxation from New York University, after which he was a law clerk to the Honorable Don N. Laramore, Circuit Court of Appeals for the Federal Circuit, Washington, DC.

Bob had an outstanding 44 year career as an internationally known and respected tax attorney. In June, he would have celebrated his 30th year with Baker & McKenzie. Some of his notable accomplishments of which he was most proud included spearheading the Florida Bar Committee whose members wrote the pivotal draft legislation to amend the Foreign Investment in Real Property Tax Act (FIRPTA), which was enacted by Congress as Code Section 1445 in 1984. In 1990, he was invited to testify before the US House of Representatives Ways and Means Committee on federal taxation of non-US investors in US real estate. He wrote extensively, particularly on international tax subjects, publishing some 100 articles. His BNA portfolio on "Federal Tax Considerations of Foreign Investment in the U.S. Real Estate" is regarded as one of the leading authorities on that subject.

Upcoming Tax Events

Upcoming Tax Events:

- 13th Annual Global Tax Planning and Transactions Workshop
  New York, NY
  March 23-24, 2016

- Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference

  Paris, France
  March 14-15, 2016

  Washington, DC
  June 8-9, 2016

- TEI's Audits and Appeals Seminar
  Santa Clara, CA
  May 17-19, 2016

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

Bob's professional associations and memberships were extensive. He was the Chairman of the Florida Bar Tax Section from 1989 to 1990. He was recently chosen to receive the Gerald T. Hart Award for Outstanding Tax Attorney of the Year which will be presented by the current Chairman of the Florida Bar Tax Section in May of this year. He learned of the recognition shortly before his passing and was excited about the event and the "roast" that went with it. Bob was an elected member of the American College of Tax Counsel. He was a member of the Advisory Board Member of BNA's *Tax Management International Journal*, the Executive Council of the U.S. Branch of the International Fiscal Association, the Florida International Bankers Association, the Florida Bar International Law Section, the American Bar Association's Committee on Inbound International Tax, the New York Bar Tax Section and STEP, the Society of Trust and Estate Tax Planners.

Bob was the past President of the Japan Society of South Florida and an active participant in the World Trade Center, the British-American Chamber, the German-American Trade Council, and the Swiss-American Chamber. He served as the Honorary Legal Advisor to Her Majesty's Britannic Consul and Co-chair of the Host Committee on the occasion of Queen Elizabeth's visit to Miami in May 1991.

Bob served as the Managing Partner of Baker & McKenzie's Miami office several times and was a great, well-respected leader to attorneys and staff alike. His clients benefitted from his brilliant intellect, clever mind and dedication to problem solving. He encouraged people to do their best and to pursue their dreams.

In addition to Edith, he is survived by his children, Daniel and Patrick, his grandchildren, Ava and William, and his siblings, Pamela and Jon. He will be remembered as a beloved husband, father, grandfather, and brother as well as a friend and mentor to many, and an inspiration to all… Bob will be greatly missed but never forgotten.

By James H. Barrett, Miami

President Obama Releases Final Budget; Tax Proposals Remain Largely Unchanged

President Obama released his Administration's final budget for fiscal year 2017 on February 8, 2016. The Budget, a copy of which can be found at www.whitehouse.gov/omb/budget, is unlikely to be seriously considered by Congress (indeed, in a break from decades of practice, Congress declined to invite the Director of the Office of Management and Budget to the Hill to testify about the Budget). Rather, the Budget should be viewed as describing President Obama's views on tax reform and setting the tone for Democratic presidential candidates by "looking forward and making sure our economy works for everybody, not just those at the top." (White House Fact Sheet: The President's Fiscal Year 2017 Budget: Overview, Meeting Our Greatest Challenges. February 9, 2016.) The Budget would lift the mandatory spending reductions known as "sequestration" in future years and would further many of the President's priorities, including: (1) investing in a "21st century transportation system" through a multi-agency initiative; (2) prioritizing research and development (including the cancer "moonshot" led by Vice President Biden and simplifying and expanding the research and experimentation (R&E) credit for companies investing in innovation); (3) advancing clean energy and addressing climate change; (4) improving access to child care, early education, and college; (5) expanding

access to job training and education for the skills needed in a 21st century economy; (6) expanding access to mental health care and addressing the prescription drug and opioid overdose epidemic; and (7) reforming the criminal justice system.

The tax proposals in this year's Budget are very similar to the proposals contained in last year's Budget, with the removal of several proposals because similar provisions were enacted during the course of the year. The provisions which have been removed include modifying the partnership audit rules; modifying the tax return due dates and automatic extension periods for certain partnership, S corporation, and C corporation income tax returns; and modifying and permanently extending the research and experimentation credit. The tax proposals in the FY 2017 Budget continue to target individual taxpayers, but also include numerous energy proposals and include the business tax reform proposals from last year's Budget.

The FY 2017 Budget continues to express strong support for international tax reform. Last year's proposals to impose a 19 percent minimum tax on foreign income, impose a one-time 14 percent tax on previously untaxed accumulated earnings of CFCs, restrict deductions under section 163(j) for "excessive" interest of members of financial reporting groups through a group wide interest expense cap, amend Code Section 7874 to limit the ability of domestic entities to expatriate, revise the definition of "intangible property" under Code Section 936(h)(3)(B) to limit shifting of income through intangible property transfers, and restrict the use of hybrid arrangements that create stateless income, are included again in the FY 2017 Budget with no substantive changes. Although there were no substantive changes to the proposals to impose a 19 percent minimum tax on foreign income and a one-time 14 percent tax on previously untaxed foreign income, Treasury's revenue estimates for these two proposals increased by over $175 billion over the ten-year window because Treasury used newly-available data from tax year 2012 to prepare its estimates. That new data, which was not available in time to prepare the estimates for last year's Budget, indicates that companies are paying less in foreign taxes than Treasury had previously projected. It is unclear what effect, if any, this increased revenue estimate will have on this year's discussions about international tax reform.

Although the R&E credit was made permanent in late 2015, the Budget proposes additional improvements and simplification to the credit, including (1) repealing the "traditional" method for computing the credit (the credit is 20 percent of qualified research expenses above a base amount related to the firm's historical research intensity from 1984-1988), (2) increasing the alternative simplified research credit (ASC) from 14 percent to 18 percent, (3) eliminating the 6 percent reduced ASC rate for businesses without qualified research expenses in the prior three years, (4) allowing the R&E credit to offset AMT liability for all taxpayers, (5) repealing a special rule for pass-through entities that limited the use of the R&E credit, (6) increasing the amount of payments to qualified non-profit organizations that may be included as contract research from 65 percent to 75 percent, and (7) repealing the requirement that R&E costs be amortized over ten years when calculating individual AMT. If enacted, these changes would be effective for expenditures paid or incurred after December 31, 2016.

The FY 2017 Budget also includes some new notable proposals, including (1) a new tax credit for businesses that hire graduates from community and technical colleges, (2) relief from US tax obligations for certain "accidental" US citizens who wish to relinquish their US citizenship, (3) a fee of $10.25 per barrel of crude oil, and (4) "improvements" in the excise tax on high cost employer-sponsored coverage under Code Section 4980I (commonly known as "the Cadillac tax").

Under the proposal for the community college partnership tax credit, there is $500 million in tax credit authority for each year from 2017 through 2021, which would be allocated annually to states on a per capita basis. The credit would be available to qualifying employers who, as certified by their state, made contributions to strengthen community college programs and hire qualifying community college graduates. Qualifying employers would receive a one-time $5,000 tax credit for each qualifying employee hired. To be a "qualified employee," the employee must be hired on a full-time, permanent basis and certified by the designated state agency as having earned a degree from a participating college program. If the employee works less than one year, the credit will be partially recaptured.

The proposal providing relief to "accidental" dual citizens appears to be designed to provide relief to individuals living abroad who discovered, often through the Foreign Account Tax Compliance Act ("FATCA") or the Offshore Voluntary Disclosure Initiative ("OVDI") compliance programs, that they also had US citizenship in addition to their foreign citizenship. The definition for such "accidental dual citizens" has multiple factors, including that the individual (1) became at birth a citizen of the US and a citizen of another country, (2) at all times up to and including the individual's expatriation date has been a citizen of a country other than the US, and (3) has not been a resident of the US since attaining age 18½.

The oil fee is highly controversial and unlikely to become law, with several Republicans announcing that it is "dead on arrival" in Congress. The fee, which would be phased in over a 5-year period beginning October 1, 2016, would apply to both domestically produced as well as imported petroleum products. There is an exemption for exported petroleum products and a temporary exemption for home heating oil. Revenues generated would be used to fund the President's 21st Century Clean Transportation Plan and 15 percent of the revenues from the fee would be dedicated to relief for households with particularly heavy energy costs.

The Cadillac tax imposes a 40 percent excise tax on employer-sponsored health coverage that exceeds a specified threshold ($10,200 for self-only coverage and $27,500 for other coverage in 2018 dollars, indexed to inflation). In response to criticism that the tax could be imposed on plans that are Chevys, not Cadillacs, and bipartisan interest in repealing the tax, the Budget proposes to increase the applicable threshold to the greater of the current law threshold or a "gold plan average premium" that would be calculated for each state. Although the proposal would be effective for taxable years after December 31, 2016, the tax will not be levied until 2020 because its implementation was delayed by the Bipartisan Budget Act of 2015.

Although the Budget proposals are generally unlikely to be enacted into law, some of the proposals—particularly those relating to international tax reform—may be considered as options when Congress holds hearings and drafts legislation addressing tax reform this year.

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

IRS Retreats on Federal Excise Tax on Reinsurance of US Risks

On December 23, 2015, the IRS announced it would no longer apply the federal excise tax on insurance under Code Section 4371 when one foreign insurance company acquires reinsurance from another foreign insurance company for a US insurance risk. The IRS issued Revenue Ruling 2016-3, 2016-3 I.R.B. 282, revoking Rev. Rul. 2008-15, 2008-1 C.B. 633. The new ruling acknowledges the IRS's loss in *Validus Reinsurance, Ltd. v. United States*, 786 F.3d 1039 (2015), for the change in position.

For background, section 4371 imposes a federal excise tax on insurance premiums paid to foreign insurance companies to insure certain US risks. Section 4371(1) generally imposes a 4 percent excise tax on premiums paid for casualty insurance issued for US insurance risks. Section 4371(2) imposes a 1 percent excise tax on premiums paid for policies covering life, health and accident risks in the US. Thus, sections 4371(1) & (2) apply the excise tax directly to premiums paid to foreign insurance companies to insure a US risk.

Section 4371(3) imposes a 1 percent excise tax on the reinsurance of a policy type covered under section 4371(1) or section 4371(2). Insurance companies that offer insurance policies may further reinsure the risk of those policies by purchasing reinsurance from another insurance company. Such reinsurance policies involve the payment of a premium by the first insurance company to the second (or reinsurance) company. Further, reinsurance companies may further reinsure the risk they acquire in reinsurance policies. The transaction of reinsuring a reinsurance policy is called a retrocession with the reinsurance company paying a premium to the retrocessionaire, i.e., the second level reinsurance company accepting the risk in the retrocession.

In Revenue Ruling 2008-15, the IRS analyzed four factual scenarios and concluded the 1 percent excise tax on foreign reinsurance policies applied in each case. In each case, the reinsurance policy involved one foreign insurance company reinsuring another foreign insurance company for a policy directly covered by sections 4371(1)-(3). In one case, the IRS concluded that the initial premium payment may be exempt from excise tax under an income tax treaty. The IRS concluded the excise tax nevertheless applied to the reinsurance premium, whether or not the foreign insurance company had also paid the excise tax on the premium of the policy being reinsured. In one situation in the ruling, the IRS concluded that the section 4371(3) excise tax applied to retrocession premiums between two foreign reinsurance companies.

In *Validus Reinsurance*, the taxpayer challenged the application of the section 4371(3) excise tax to retrocession premiums. The taxpayer was a foreign insurance company that did not operate a US trade or business. The taxpayer reinsured US risks subject to the section 4371(3) excise tax. The taxpayer further paid retrocession premiums with respect to the reinsurance of US risks (which the court labeled “second-level reinsurance”). The taxpayer challenged the application of the section 4371(3) excise tax with respect to the retrocession premiums. The appellate court affirmed the district court's grant of summary judgment in the favor of the taxpayer. In evaluating the arguments, the appellate court stated:

> Because both parties offer plausible interpretations based on different readings of the statutory text, we conclude the text of section 4371 is ambiguous with regard to its application to wholly foreign retrocessions. This statutory ambiguity is resolved by the presumption against extraterritoriality.

The appellate court went on to hold for the taxpayer based on the presumption against extraterritoriality. For further discussion, please see Tax News and Developments article, *The DC Circuit Rejects the IRS's Attempt to Tax a Wholly Foreign Transaction,* published on August 25, 2015 and available under publications at www.bakermckenzie.com.

In Revenue Ruling 2016-3, the IRS acknowledges the loss in *Validus Reinsurance* and revokes Revenue Ruling 2008-15. The IRS states that it will continue to apply the section 4371(3) excise tax to reinsurance premiums paid to foreign insurance companies by foreign insurance companies that elect to be taxed as a US insurance company under Code Section 953 or that have a US trade or business selling insurance policies. The ruling is a welcome development for insurance companies worldwide. Hopefully the IRS will now begin to process the many excise tax refund claims that have been submitted based on the *Validus Reinsurance* case.

By Robert S. Walton, Chicago

Are LOB Provisions in Tax Treaties EU Proof?

On November 19, 2015, the European Commission ("EC") announced that it issued a reasoned opinion as part of its infringement procedures, requesting the Netherlands to amend the limitation on benefits ("LOB") provision in the tax treaty between the Netherlands and Japan (the "Treaty"). According to the EC, the LOB provision in the Treaty violates the Freedom of Establishment as set out in article 49 of the Treaty for the EU ("TFEU") since certain entities are denied specific benefits under the Treaty based on the residency of its shareholders or the stock exchange on which shares in the entity claiming benefits under the Treaty, or its direct or indirect shareholders, are traded. Since the Netherlands did not respond to the request by the deadline of January 19, the EC may refer the Netherlands to the Court of Justice of the EU.

Reasoned Opinion

The EC's request to the Netherlands was announced as part of the November infringements package in which the EC stated that its request was based on previous case law arguing that a Member State concluding a tax treaty with a third country is not allowed to negotiate a better treatment for entities held by shareholders in its own country of residence than for comparable companies held by shareholders resident in other EU Member States.

Based on the announcement, it appears that the EC believes that the direct or indirect 'stock exchange test' under article 21(2)(c) of the Treaty and the 'derivative benefits' test under article 21(3) of the Treaty include favorable treatment to Dutch entities owned by Dutch shareholders or traded on a Dutch stock exchange to qualify for benefits of the Treaty. The announcement reflects the EC's view that this favorable treatment compared to Dutch entities with non-Dutch EU shareholders or traded on an EU stock exchange outside the Netherlands is in conflict with the fundamental freedoms of the EU.

Although Member States in principle have the sovereignty to conclude bilateral tax treaties, according to the EC, case law, such as C-55/00 *Gottardo* and C-466/98 *Open Skies*, requires Member States to consider EU law when exercising their sovereign authority to conclude tax treaties with other states and further holds that denying treaty benefits based on the nationality of a company's shareholders is discriminatory and therefore in conflict with EU law. Therefore, the EC requested the Netherlands to amend the LOB-provision to prevent companies in a comparable situation being treated unequally such that they suffer higher Japanese withholding taxes.

Stock Exchange Test

Under the stock exchange test in the Treaty, a company generally qualifies for the benefits of the Treaty if its principal class of shares is listed on a recognized stock exchange and is regularly traded on one or more recognized stock exchanges. Which stock exchanges are recognized is defined in article 21(8)(c) of the Treaty. This list is in principle limited but a provision is included providing the competent authority of both contracting states the authority to agree to recognize any other stock exchange. The current list includes a large number of non-Dutch EU stock exchanges, but it does not include all EU stock exchanges.

Given that certain European stock exchanges are not included in the definition of recognized stock exchange, the EC argues that this could limit the Freedom of Establishment since companies which have their shares listed on a Dutch stock exchange may incur lower Japanese withholding taxes than companies which have their shares listed on a non-Dutch stock exchange. As a Member State concluding a tax treaty with a third country, the EC takes the view that the Netherlands should not have agreed to beneficial treatment of Dutch companies with shares listed on a Dutch stock exchange as compared to other EU stock exchanges. The provision that other stock exchanges can be appointed as recognized for purposes of the treaty apparently does not alter the EC's opinion.

Derivative Benefits Test

A company can qualify for the benefits of the Treaty under the derivative benefits test of article 21(3) if shares representing at least 75 percent of the voting rights in said company are owned by seven or fewer companies that qualify as equivalent beneficiaries. The main requirement to qualify as an equivalent beneficiary is that a company resident in a state other than the Netherlands or Japan qualifies for a similar reduced tax rate under a tax treaty between their country of residence and the country of the source of the income (*i.e.* Netherlands or Japan). For example, if a French company owns all shares in a Dutch company which owns all shares in a Japanese company, the dividend withholding tax on a dividend paid by the Japanese entity may be reduced under the Treaty. If the Dutch company does not satisfy other LOB provisions under the Treaty, the dividend withholding tax may still be reduced to 0 percent provided that the French shareholder of the Dutch entity would qualify for a 0 percent dividend withholding tax rate under the French - Japanese tax treaty if it were to be a direct shareholder in the Japanese entity.

However, if for example the shareholder of the Dutch company was resident in another state which has a tax treaty with Japan under which the maximum reduction is a withholding tax rate of 5 percent on dividends, such company would not qualify as an equivalent beneficiary and the benefits of the Treaty (or at least, the reduction of the Japanese withholding tax to zero) may be denied to

the Dutch company. This means that effectively, Dutch companies with Dutch resident shareholders would be treated preferentially under this provision since they would automatically qualify as equivalent beneficiaries. The EC requested the Netherlands to amend this beneficial treatment based on the place of residency of the shareholders of a company applying for benefits of the Treaty. This means that effectively the Netherlands is forced to renegotiate the Treaty to eliminate the presumed discriminatory provisions. Obviously, such a solution would be possible only if Japan were also prepared to agree to liberalize the LOB provision in such a manner.

Conflict with Freedom of Establishment

Based on case law such as C-55/00 *Gottardo* and C-466/98 *Open Skies*, the EC believes that the Netherlands concluded a tax treaty that is in conflict with the Freedom of Establishment. Therefore, the EC believes that the treaty should be amended to repair the violation of this fundamental freedom. Since LOB provisions are included in a large number of other tax treaties between EU Member States and other non-Member States, this decision by the EC may impact any of such tax treaties containing similar provisions as the stock exchange test or the derivative benefits test. Given that virtually every tax treaty concluded by the US with Member States contains an LOB provision, this means that all these treaties may be in conflict with the EU fundamental freedoms.

If the Court of Justice of the EU finds that the LOB provision in the Treaty is in conflict with the fundamental freedoms, arguably the Member State that concluded the tax treaty containing the conflict with EU law can be held liable for damages to the taxpayer that suffered the discrimination. In such case, the Member State should reimburse the taxpayer for the withholding tax incurred to the Member State's treaty partner under the discriminatory provision. However, whether a Member State is in fact liable for damages and what the effective damages are, should be determined on a case-by-case basis and strict conditions must be met. One of the conditions for liability that must be met in this respect, is whether including an allegedly discriminatory LOB provision in a tax treaty (or maintaining such provision after the infringement procedure) is a sufficiently serious breach of EU law. Given that typically a non-Member State (*e.g.* US and Japan) insists on including an LOB provision in a tax treaty, it can be argued that the alleged breach of EU law is involuntary from the respective Member States' perspective. On the contrary it can be argued that the respective Member State should have included an EU dimension in the LOB provision at breach.

Are LOB-provisions EU-proof?

The discussion on the compliance of LOB provisions with EU law is not new. This potential conflict with EU law was already brought to the attention of the European Commission by questions asked by a member of the EU Parliament in 1990 and addressed in the Ruding Report in 1992. It is quite remarkable that the reasoned opinion by the EC virtually coincides with the release of a statement in the Anti Tax Avoidance Package that LOB "clauses limit the benefits of tax treaties to entities owned by residents of only one Member State, and therefore can be seen as detrimental to the Single Market by discouraging cross border investment. These rules can be problematic for the Capital Markets Union."

The EU dimension of LOB provisions is very relevant in view of the discussion regarding the recommended anti-abuse provision under BEPS Action Item 6 and the draft of a multilateral instrument as advocated under Action Item 15. Should the EC take this case to the Court of Justice of the EU, the outcome of this procedure may have a major impact on the compliance of anti-abuse provisions with EU law. It appears that the EC is emphasizing that an EU dimension should be included in general anti-abuse rules in bilateral or multilateral agreements concluded by Member States with non-EU Member States. In this respect, it is worthwhile noting that in the EC's recommendation on the implementation of measures on tax treaty abuse which it issued as part of the EU anti-BEPS package in January, the EC indicates a preference for a principle purpose test over an LOB- provision.

Notwithstanding the above, if LOB provisions similar to the LOB-provision in the Treaty are included in existing tax treaties between Member States and third states, the EC apparently considers them to violate EU law. With respect to the (re)negation of a tax treaty, with this decision, the EC urges Member States to include an EU dimension in treaty anti-abuse provisions. This may ultimately lead to LOB provisions that are less strict.

By Wouter A. Paardekooper and Roeland Bavinck, Amsterdam

The State Tax "Side Effect" of Doing Business in the United States

Occasionally, a non-US corporation's expansion of its business into the United States has unforeseen or unintended state income tax consequences. While federal income taxation is generally a matter of primary concern when a non-US corporation starts conducting business in the United States, the conclusions reached on federal income taxation do not necessarily carry over for state income tax purposes. For example, many companies are surprised to learn that a lack of federal income tax jurisdiction does not necessarily equate to a lack of state tax jurisdiction and that a lack of federal taxable income does not necessarily equate to a lack of state taxable income. In this article, we discuss some of the main differences between the federal income taxation and state income taxation of non-US corporations.

Who is Subject to Tax?

As a threshold matter, under fundamental principles of US federal constitutional law, a state may not impose a tax unless the imposition satisfies the requirements of both the Due Process and Commerce Clauses of the US Constitution.

The Due Process Clause requires some "minimum connection" between the state and the person it seeks to tax, and is concerned with the fairness of the governmental activity. A Due Process Clause analysis focuses on "notice" and "fair warning," and the Due Process nexus requirement will be satisfied if an out-of-state company has purposefully directed its activities at the taxing state.

The Commerce Clause, on the other hand, requires a "substantial nexus" between the state and the person, property, or transaction being taxed or required to collect tax. Importantly, the substantial nexus standard is not equivalent to the jurisdictional standard that applies for federal income tax purposes. Additionally, states are not bound by federal tax laws or by income tax

treaties. Thus, when a non-US corporation has "substantial nexus" with a taxing state, that state may impose a corporate income tax (or other business activity tax) on that corporation regardless of whether that same corporation is subject to federal income tax. Accordingly, it is critical to analyze the issue of whether a corporation has substantial nexus with a state independently from whether the corporation is subject to federal income tax.

A corporation will generally have substantial nexus with a state if that corporation has more than a *de minimis* physical presence in the state. A physical presence may be established through the presence of a corporation's own employees or property (real or tangible personal property) in the state or through the presence of a third party (including an independent agent) that conducts market-enhancement activities in the state. This physical presence standard generally aligns with the standard for having a US trade or business under federal income tax principles, but is less stringent than the standard that generally applies under income tax treaties, pursuant to which a corporation may not be subject to federal net income tax unless its presence in the US rises to the level of a "permanent establishment" (which generally requires a fixed place of business in the US through which its business is conducted either directly or through a dependent agent).

However, where things really differ between federal and state income tax jurisdiction is in those states that have adopted a so-called "economic nexus" standard. States that have adopted an economic nexus standard generally subject a corporation to income tax (and consider a corporation to have substantial nexus with the state for income tax purposes) if that corporation has a sufficient economic connection with the state. Examples of activities that can create economic nexus with a state include licensing a trademark for use in the state or earning a certain threshold amount of receipts (typically, ranging from $250,000 to $1,000,000) from customers located in the state (also known as "factor presence nexus"). Corporations that may otherwise be subject to state taxation as a result of economic nexus standards should consider whether they qualify for protection from such taxation under a US federal statute known as Public Law 86-272. Public Law 86-272 exempts certain sellers of tangible personal property from state income taxation if the only activities conducted in the state are sales solicitation activities (i.e., direct sales activities or those activities ancillary thereto).

While the validity of economic nexus has never been addressed by the Supreme Court of the United States (indeed, the Supreme Court has repeatedly declined to hear cases on economic nexus), the validity of economic nexus has been litigated and upheld by many state courts. Thus, a non-US corporation that is merely earning receipts from customers in a state may be subject to that state's corporate income tax. Accordingly, careful attention should be paid to both the quantitative and qualitative aspects of activities conducted in the US by non-US corporations.

How is the Tax Computed?

If a state has jurisdiction to impose an income tax on a non-US corporation, the next question involves how that tax is computed. A corporation's state tax base may vary from its federal income tax base (which, in some cases, could be zero).

Generally, states use federal taxable income as the starting point for computing state taxable income, with certain addition or subtraction modifications, and then

allocate or apportion that tax base to the state using an apportionment formula consisting of one or more factors (typically, the percentage of the corporation's gross receipts, payroll and/or property within the state).

Because states generally use federal taxable income as the starting point for computing state taxable income, a corporation that has no federal taxable income may consequently have no state taxable income. However, several states explicitly require corporations to include in their state tax base income that is not otherwise included in their federal income tax base. For example, a non-US corporation that does not have a permanent establishment under an applicable treaty may be required to include in its state tax base all of its worldwide income, or income that it would have been required to include in its federal tax base if it were not treaty protected.

Likewise, a non-US corporation that does have federal taxable income may be required to include in its state income tax base other items of worldwide income that may have been excluded from its federal income tax base. For federal income tax purposes, a non-US corporation is only subject to net income tax on income that is “effectively connected” to the corporation’s US trade or business, meaning that the non-US corporation must separately account for its items of income and deductions connected to its US trade or business. States, on the other hand, have generally rejected such a separate accounting method in favor of formulary apportionment. Thus, a non-US corporation may be subject to state income tax on an apportioned share of its worldwide income, even though the corporation may only be subject to federal income tax on its “effectively connected” income.

Additionally, states may require corporations to file returns on a combined basis, namely a “unitary” combined basis, with other related corporations. As a result, a corporation with substantial nexus in a state may be required to compute its income or business activity tax liability based on the combined incomes (after intercompany eliminations) and combined apportionment factors of all of its “unitary” affiliates. This requirement applies regardless of corporate formalities and regardless of whether those affiliates have substantial nexus with the state. A “unitary” business determination is a factual inquiry, but the common hallmarks of a unitary business include business activities that experience a flow of value as evidenced by functional integration, centralized management and economies of scale. Moreover, while some states limit the entities included in the combined report to entities located in the US (known as a “water’s-edge” combination), others require the inclusion of all worldwide affiliates as a default (although a water’s-edge election may be available), while still others require the inclusion of certain income from “foreign” corporations even in a so-called water’s-edge combination. There has also been a recent trend of expanding the entities in a water’s-edge report to include entities domiciled or operating in so-called “tax havens” (which are determined through either a specific list of jurisdictions or after application of a test that examines various factors, include the lack of transparency in a jurisdiction).

Because of the significant differences between state and federal income taxation of non-US corporations, expanding business operations into the US may have unintended state tax consequences. Non-US businesses should carefully consider the potential state income tax consequences of any US business operations.

By Maria P. Eberle and Lindsay M. LaCava, New York

California Shaves Off its MTC Refund Claims for the New Year

On December 31, 2015, the California Supreme Court issued its long-awaited opinion in *Gillette Co., et al. v. Franchise Tax Board*, 363 P.3d 94, addressing whether The Gillette Company and several other California corporate taxpayers (collectively, “Gillette”) were permitted to elect to use the Multistate Tax Compact’s evenly-weighted, three-factor apportionment formula comprised of property, payroll, and sales factors (“MTC Formula”) in lieu of the three-factor apportionment formula with a double-weighted sales factor (*i.e.*, property, payroll, and double-weighted sales factors) subsequently enacted by the state (“Double-weighted Sales Formula”) in 1993. The California Supreme Court held that the California legislature not only had the power to override the Compact election contained in the California statutes, but that it also intentionally exercised that power when it statutorily mandated the use of the Double-weighted Sales Formula. This holding would result in a denial of the taxpayers’ refund claims of approximately $34 million, which were premised on the election and application of the MTC Formula to their franchise tax returns filed between 1993 and 2005.

The court’s decision unanimously reversed the Court of Appeal’s holding that California’s adoption of the Compact, which provided taxpayers with the ability to elect to use the MTC Formula, superseded the subsequent implementation of the Double-weighted Sales Formula. The Court of Appeal’s decision was based on its finding that the Compact was a valid, enforceable interstate compact, *i.e.*, a binding contract between member states that ceded sovereignty over the covered subject matters. Accordingly, the Court of Appeal elevated the Compact over unilateral state legislation such as California's adoption of the Double-weighted Sales Formula and further held that the attempt to remove the option to elect the MTC Formula would be in violation of the federal and state Contract Clauses, forbidding enactment of state laws impairing contractual obligations, and the Reenactment Rule of the California Constitution, providing that “[a] section of a statute may not be amended unless the section is reenacted as amended.”

When is a Compact not a Compact?

The California Supreme Court’s reversal of the Court of Appeal appears to be the natural result of a fundamental disagreement over the nature of the Compact. Unlike the Court of Appeal, the California Supreme Court found that Compact was not a binding, reciprocal agreement. In making its determination, the court, at the urging of the Multistate Tax Commission (“Commission”) that was created by the Compact, applied a test derived from *Northeast Bancorp v. Board of Governors, FRS*, 472 US 159 (1985), to determine whether the Compact was a binding compact or merely a model uniform law. The *Northeast Bancorp* test examines the following factors to determine whether a compact exists:
(i) whether a joint organization was formed to regulate the subject matter;
(ii) whether there was conditional consent by member states which prevented member states from unilaterally modifying or repealing their law; and, most importantly, (iii) whether reciprocal obligations between member states were created. The court found that none of these factors were present, and that the Compact was not a binding, interstate compact.

As for the first factor, the court found that, although the Compact established the Commission, the Commission was not a joint regulatory organization because it "…has no authority ordinarily associated with a *regulatory* organization." The court agreed with the Commission's characterization of its powers as being "strictly limited to an advisory and informational role" and noted that "[t]he Commission simply has no binding regulatory authority upon member states. Whatever power the Commission has to promulgate regulations or conduct audits exists solely at the pleasure of each member state."

With respect to the second factor, the court found that the effectiveness of the Compact did not depend on the conduct of other members, because any state may join the Compact by enacting its provisions into law and may unilaterally decide to leave the Compact without notice. In further support of its finding that the Compact did not prohibit unilateral state action, the court noted the fact that the Commission continued to recognize Florida as a member in good standing of the Compact and the Commission even after Florida unilaterally eliminated certain Compact articles from its statutes.

In its review of the third and most important factor of the *Northeast Bancorp* test, the court found that reciprocal obligations did not exist as a result of the Compact, as the availability of the MTC Formula election provision in a state benefited taxpayers regardless of whether the taxpayer is from a member or nonmember state. The court's conclusion was supported by Gillette's admission "…that 'party states do not perform or deliver obligations to one [another]' and 'have no incentive to enforce the Compact,' which 'is not the type of contract where the parties exchange obligations and are in a meaningful position to gauge each other's compliance.'" Ultimately, the Compact was deemed to be "more akin to the adoption of a model law rather than the creation of any mutual obligations among compact members."

Because none of the indicia of the *Northeast Bancorp* test existed, the Compact election adopted in the California statutes was merely state law subject to change at the legislature's discretion, not a binding, interstate compact that should be elevated over subsequent state legislation, such as California's adoption of the Double-weighted Sales Formula. As the Compact was not a contract, presumably the federal and state Contract Clauses were not violated by the adoption of the Double-weighted Sales Formula, though this point was not specifically addressed by the court. The court did address the Reenactment Rule and found that the statutory language implementing the Double-weighted Sales Formula did not violate the Reenactment Rule because it expressly referenced the Compact, which was "strong evidence that the Legislature acted with the Compact in mind."

If the Compact isn't a Compact in California, is it a Compact Anywhere?

Taxpayers have made similar Compact election arguments in several other states, namely Michigan, Minnesota, Oregon, and Texas, and it remains to be seen how the litigation in those states will be impacted by the California Supreme Court's decision in Gillette, which is the first state supreme court to directly address the nature of the Compact. (N.B.: Although the Michigan Supreme Court previously ruled on the availability of the Compact election in *International Business Machines Corp. v. Dept. of Treasury*, 496 Mich. 642 (2014), the nature of the Compact was not specifically addressed. In an unusual turn of events involving retroactive legislation, the Michigan Supreme Court could potentially revisit the MTC Formula election issue later this year. For previous updates regarding Compact litigation, please refer to prior *Tax News and Developments*

article, *Multistate Tax Compact Litigation: 3-Factor Apportionment Election Update*, published in October 2015 and available under publications at www.bakermckenzie.com.)

The California Supreme Court's decision could influence how other states view the Compact, but it is quite possible that other states view the Compact differently, perhaps in line with the California Court of Appeal. If there was a disagreement among the states as to the nature and effect of the Compact, the US Supreme Court could be more inclined to grant certiorari, if Gillette appeals to the US Supreme Court, as expected. Even if there was not a split among the states on this issue, the US Supreme Court could plausibly grant certiorari on one of the several federal questions surrounding the nature and effect of the Compact. If the US Supreme Court denies certiorari, *Gillette* will be the end of the road for taxpayers with California Compact Election cases, but it is fair to say that it will not be the end of Compact election drama in other states.

By John Paek, Palo Alto and Julie Townsley, Chicago

New York's 'Reformed' Regulations

Beginning in October 2015, the New York State Department of Taxation and Finance has been releasing draft regulations that will implement New York's extensive corporate franchise tax reform. The initial draft regulations addressed three topics: nexus, sourcing of other services and other business receipts, and sourcing of receipts from sales of digital products.

The draft nexus regulations incorporate the new tax law's economic nexus provisions. (See N.Y. Tax Law Section 209.1(a).) The draft sourcing regulations implement the market-based sourcing hierarchies contained within the Tax Law for other service receipts and other business receipts and receipts from sales of digital products. (See N.Y. Tax Law Sections 210-A(4) and 201-A(10)).

Maria Eberle and Lindsay LaCava examine the most significant aspects of the draft nexus and sourcing regulations and compare New York's new sourcing provisions for general services to California's market based sourcing regime and the Multistate Tax Commission's draft market-sourcing regulation in their article, *New York's 'Reformed' Regulations.* This article originally appeared in the December 18, 2015 issue of Bloomberg BNA's *Tax Management Weekly State Tax Report*, and is also available under publications at www.bakermckenzie.com.

Canadian Tax Update

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

Canada Introduces Exemption to Withholding Obligations for Non-Resident Employers

In its 2015 Budget, the Canadian federal government announced proposed amendments to exempt "certified" non-resident employers from the obligation to withhold income tax from remuneration paid to certain non-resident employees for duties performed in Canada. The Canada Revenue Agency ("CRA") recently released the application form that non-resident employers must use to obtain certification (Form RC473, *Application for Non-Resident Employer Certification*).

Although the amendments have not yet been enacted into law, if the amendments are enacted as proposed, they will be effective retroactively for payments made after 2015. A non-resident employer must, however, apply to the CRA for certification on or before March 1, 2016 to be considered for an effective date of January 1, 2016.

A non-resident employer is generally required to withhold and remit Canadian income tax from remuneration paid to a non-resident employee performing duties in Canada. This obligation exists even if the employee is exempt from Canadian income tax because of a tax treaty. For example, the Canada-US tax treaty generally exempts remuneration of a non-resident employee from Canadian income tax where:

(i) the remuneration does not exceed $10,000; or

(ii) the employee is not in Canada for more than 183 days in the year and the income is not borne by a permanent establishment in Canada.

The non-resident employee must then file an income tax return in Canada for a refund of amounts withheld and remitted. In the past, relief from withholding obligations could only be obtained by waiver from the CRA on an employee-by-employee basis. Certification under the proposed amendments will relieve the employer of the obligation to withhold income tax from amounts paid to all qualifying non-resident employees for a period of up to two years.

Conditions for Certification

To qualify for certification, a non-resident employer that is not a partnership must be resident in a country with which Canada has a tax treaty. If the non-resident employer is a partnership, at least 90 percent of the partnership's income or loss for the relevant fiscal year must be allocated to members that are resident in countries with which Canada has a tax treaty. The non-resident employer must also agree to certain conditions imposed by the CRA, including that it will:

(i) evaluate and document whether and how its employees qualify for the exemption;

(ii) obtain a CRA business number;

(iii) file the applicable Canadian income tax returns; and

(iv) make its books and records available in Canada on request of the CRA for the purpose of verifying that it is meeting the conditions for certification and its withholding obligations.

"Qualifying Non-Resident Employees"

Non-resident employer certification will provide an exemption with respect to qualifying non-resident employees only; the non-resident employer must continue to withhold and remit Canadian income tax from remuneration paid to non-qualifying non-resident employees (unless a waiver has been obtained in respect of the employee). To qualify in respect of a payment, the non-resident employee:

(i) must be resident in a country with which Canada has a tax treaty at the time of the payment;

(ii) must not have to pay tax on the payment in Canada because of the treaty; and

(iii) must either work in Canada for less than 45 days in the year that includes the payment **or** be present in Canada for less than 90 days in any 12-month period that includes the payment.

Note that unless otherwise exempt, a certified non-resident employer must still withhold and remit Canada Pension Plan and Employment Insurance premiums.

New Brunswick Raises HST to 15 Percent

In its 2016-2017 Budget, the New Brunswick government announced a 2 percent increase to the provincial portion of the Harmonized Sales Tax (HST). The new HST rate of 15 percent will be effective July 1, 2016.

By Randall Schwartz and Stephanie Dewey, Toronto

Treasury Issues Proposed Regulations Implementing Country-by-Country Reporting Rules

Treasury and the IRS issued proposed regulations on December 21, 2015, to implement BEPS Action Item 13, Transfer Pricing Documentation and Country-by-Country Reporting. The Proposed Regulations require US multinational groups with at least $850 million in annual global revenues to prepare country-by-country (CbC) reports on their operations and tax positions and file those CbC reports with the IRS. The IRS is developing a new tax form that is expected to be consistent with the model template created for Action Item 13. Under Action Item 13 and competent authority arrangements that Treasury and the IRS currently are contemplating, the IRS automatically will exchange CbC reports with other jurisdictions that satisfy the US's confidentiality and permissible use requirements. Although Action Item 13 calls for the first CbC reports to be filed for taxable years beginning on or after January 1, 2016, there likely will be a delay in the US filing requirement because the Proposed Regulations only will be effective for the US parent entity's taxable year beginning on or after the date that final regulations are published. Comments on the Proposed Regulations are due by March 22, 2016.

For a full discussion of the Proposed Regulations, please see previously released Tax Client Alert, *IRS Proposes Regulations Implementing Transfer Pricing Country-by-Country Reporting*, distributed on February 2, 2016, and available under publications at www.bakermckenzie.com.

Properly Allocating Costs to Nondeductible Lobbying Activities

Election season provides an opportunity for companies to take a closer look at their lobbying expenses and confirm that they are appropriately allocating costs to nondeductible lobbying expenses under a reasonable allocation methodology. In an article published in the January/February 2016 issue of the *Journal of Corporate Taxation*, *Is Your Company Using the Best Method for Allocating Costs, Including Compensation-Related Costs, to Nondeductible Lobbying Activities?*, Anne Batter and Alexandra Minkovich provide an overview of the rules governing the tax treatment of lobbying expenses and consider when each method for allocating costs to lobbying expenses is most beneficial. As discussed in the article, a key factor in the determination of which method will prove most beneficial to a company is the company's compensation structure, as well as the extent and nature of its overhead costs.

For the complete article, please see *Is Your Company Using the Best Method for Allocating Costs, Including Compensation-Related Costs, to Nondeductible Lobbying Activities?*, also available under publications at www.bakermckenzie.com.

Recently Enacted “PATH” Act Drastically Changes and Improves US Federal Income Tax Rules for Certain Foreign Retirement and Pension Funds Investing in Real Estate in the US

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (PATH, the “Act”), which includes spending and tax provisions such as permanent and temporary extender provisions for individuals and businesses, “program integrity” provisions aimed at reducing improper claims and the amount of improper refunds paid, tax administration provisions addressing declining customer services levels and increased concerns about identity theft at the IRS, and provisions relating to the US Tax Court.

The Act also contains a provision that makes changes to the rules for real estate investment trusts (“REITs”) and the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), which, as a general matter, specifically imposes US federal income tax, US tax return filing requirements, and US withholding tax on foreign investment in US real property. This newly-enacted FIRPTA exemption dramatically changes and improves the US federal income tax rules for investments in real estate in the US by foreign retirement and pension funds that qualify for the exemption.

For a full discussion of the newly-enacted FIRPTA exemption, please see previously released Tax Client Alert, *The Recently Enacted “PATH” Act of 2015 Drastically Changes and Improves the US Federal Income Tax Rules for Certain Foreign Retirement and Pension Funds Investing in Real Estate in the United States*, and for a general overview of the Protecting Americans from Tax Hikes Act of 2015, please also see previously released Tax Client Alert, *President Signs Omnibus Bill Containing Appropriations, Tax Provisions*, both distributed on December 30, 2015. Both alerts are also available under publications at www.bakermckenzie.com.

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Save the Dates: Baker & McKenzie Announces Spring Global Tax, Transfer Pricing and Controversy Conference Dates

This spring Baker & McKenzie is pleased to invite you to four multi-day events being held in Paris (March 14-15), New York (March 23-24), Santa Clara (May 17-19) and Washington, DC (June 8-9). Each program is designed to keep clients and friends of the Firm informed of the latest legislative developments changing the global tax landscape and provide attendees with a forum for an interactive discussion on the issues affecting US and multinational corporations today.

13th Annual Global Tax Planning and Transactions Workshop

Baker & McKenzie returns to the Big Apple for its annual Global Tax Planning and Transactions Workshop, ***Forging a Way Forward in an Evolving Tax Environment***, taking place at the Marriott Marquis on Wednesday, March 23 and Thursday March 24, 2016. Bringing together over 50 Baker & McKenzie practitioners from around the globe, this premier event offers sessions on key international tax developments facing inbound and outbound companies. This year's Workshop will also feature keynote luncheon speaker, **Robert Stack, Deputy Assistant Secretary, International Tax Affairs from the US Department of Treasury**.

Throughout the multi-day program, corporate tax attendees have the opportunity to participate in breakout sessions centered around four topical tracks: *Tax 101: The Building Blocks of Tax Planning and Transactions*; *Global Tax Planning, M&A and Transfer Pricing Topics*; *Interplay Between Tax Planning and Other Disciplines*; and *A Deeper Dive into Developments with Significant Impact to Multinationals*. As in previous years, the Workshop will also offer interested companies the opportunity to meet one-on-one with Baker & McKenzie tax practitioners on Tuesday, March 22, and Wednesday, March 23 to discuss issues of current concern. For full conference details, agenda and registration information, please visit the event's web page at www.bakermckenzie.com/EventTaxAnnualGlobalTaxMar16/.

Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference Series

As countries begin to enact new legislation in response to the BEPS Project, Baker & McKenzie and Bloomberg BNA continue to keep corporate tax practitioners apprised of the ever changing tax landscape with their ***2016 Global Transfer Pricing Conference Series***. The first conference of the series will be held in Paris on March 14-15 and will be followed shortly after by the second in the series, which will take place in Washington, DC on June 8-9. This two-day international conference brings together Baker & McKenzie transfer pricing practitioners, along with government officials, policy makers and leading industry experts for a first-hand look at the transfer pricing issues that may arise as a result of the interpretations and implementations of the OECD's BEPS report. Registration and agenda information for the Paris conference is available at www.bna.com/2016-global-transfer-pricing-paris. Those interested in attending the Washington, DC conference will find agenda, speaker and registration details

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on the conference webpage, located at www.bna.com/2016-global-transfer-pricing-washington-dc. Additional information for the fall conferences in the series, to be held in Toronto and Hong Kong, will be available soon.

2016 TEI Audits & Appeals Seminar

Baker & McKenzie is once again proud to sponsor a full day of international tax controversy instruction during the Tax Executives Institute 2016 Audits and Appeals Seminar, held in Santa Clara, California on May 17-19, 2016. Join our tax practitioners for interesting and informative discussions with representatives from tax authorities on ways to manage international tax controversies in challenging jurisdictions. Topics will include a focus on tax legislative developments in Brazil, Mexico, India and China. For more information and instructions on how to register, please visit www.bakermckenzie.com/eventtaxauditappealsseminarmay16/.

We hope to see you at one of our events this spring! For a complete listing of our upcoming events, please visit www.bakermckenzie.com/tax/event.

Correction: Please note in the December 2015 issue of *Tax News and Developments,* the article titled, *IRS Issues Final Regulations on Transactions Qualifying as Tax-Free "F" Reorganizations,* published in the *Tax News and Developments* contained an error that has since been corrected. We have added the highlighted language to clarify the following sentence: "The result of this change is that, under the Final Regulations, Code Section 356 will **not** apply to a distribution of cash or property made pursuant to an F reorganization."

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

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