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In This Issue:

Baker & McKenzie Lawyers Testify at Treasury/IRS Hearing on Proposed 385 Regs

Joshua D. Odintz and Joseph (Jud) B. Judkins, both from Baker & McKenzie's Washington, DC office, testified before a full house at the Treasury/IRS hearing on the proposed Code Section 385 regulations on Thursday, July 14, 2016 (for a full discussion on these proposed regulations, please see previously released North America Tax Client Alert, *US Treasury and IRS Propose Regulations Under Code Section 385*, distributed on April 19, 2016 and available under insights at www.bakermckenzie.com). The panel was composed of officials from the Treasury Department's Office of Tax Policy and the IRS Office of Chief Counsel, and included: Filiz Serbes, Special Counsel, Associate Chief Counsel (Corporate), IRS; Kevin Jacobs, Senior Technical Reviewer, Associate Chief Counsel (Corporate), IRS; Raymond Stahl, Special Counsel, Associate Chief Counsel (International), IRS; Austin Diamond-Jones, Attorney, Associate Chief Counsel (Corporate), IRS; Kevin Nichols, Senior Counsel, Office of International Tax Counsel (Treasury); and Brett York, Attorney-Advisor, Office of Tax Legislative Counsel (Treasury). Other government officials who attended the hearing, but did not participate, included Andrew Keyso, Senior Advisor to Commissioner Koskinen; Tom West, Tax Legislative Counsel (Treasury); Krishna Vallabhaneni, Deputy Tax Legislative Counsel (Treasury); Marjorie Rollinson, Associate Chief Counsel (International), IRS; and John Merrick, Special Counsel, IRS Office of Chief Counsel (International).

General Overview of the Hearing

Sixteen commenters spoke at the hearing, 15 of whom advocated for either a complete withdrawal of the proposed regulations or significant modifications. Most of the commenters represented industry associations, including the National Foreign Trade Council, the U.S. Chamber of Commerce, the United States Council for International Business, the Retail Industry Leaders Association, the Organization for International Investment (OFII), the Institute of International Bankers, the Associated General Contractors of America, and the National Association of Manufacturers. Others represented law and accounting firms, including Odintz and Judkins, who spoke on behalf of Baker & McKenzie, and not on behalf of the Firm's clients. (To read Baker & McKenzie's public comments, please visit: http://f.datasrvr.com/fr1/616/20775/Baker__McKenzie_Section_385_Comments.pdf). Only one commenter − Samuel C. Thompson, Jr., a professor at Penn State Law − advocated for the proposed regulations to be finalized as proposed, with a few suggestions for expansions. The government panelists generally listened respectfully to the commenters and asked no substantive questions.

Upcoming Tax Events

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

  Hong Kong
  September 19-20, 2016
  *Register with corporate guest code **BAKHK16***

- Baker & McKenzie/Bloomberg BNA Spinoffs Conference

  New York, NY
  September 29, 2016

- State and Local Tax Roundtable

  Dallas, TX
  September 13, 2016

  Minneapolis, MN
  October 4, 2016

- Breakfast Briefing - Dutch Tax Developments

  Chicago, IL
  October 5, 2016

- 17th Annual Tax and Trusts Training Program

  Miami, FL
  October 27-28, 2016

- Baker & McKenzie/TEI Houston Global Tax Symposium

  Houston, TX
  November 2, 2016

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

The commenters (with the exception of Thompson) generally agreed that the proposed regulations were overly broad and far-reaching, and noted the significant impact that the regulations would have, if finalized, on industries and transactions that have nothing to do with the stated policy objectives motivating the regulations. Several commenters questioned the validity of the regulations and whether Treasury has the authority to issue the proposed regulations under section 385. Many commenters also noted that the comment period was not long enough for them to completely review and analyze the proposed regulations' far-reaching effects and, as a result, their comments should only be considered to be preliminary. If Treasury does not completely withdraw the proposed regulations, many commenters requested a prospective, delayed effective date (common requests included "no earlier than January 1, 2019" or "no earlier than 18-24 months after the final regulations are published in the Federal Register").

Many of the industry representatives criticized the government's presumption that all intercompany debt is tax-motivated and provided numerous examples of how intercompany debt furthers legitimate and valid business operations. The proposed regulations, if finalized, would impact the day-to-day operations of nearly every company. These commenters raised concerns that finalizing the proposed regulations would require them to rely on more expensive third party debt, chill investment and job expansion, and counteract existing incentives in ways that discourage − rather than promote − economic efficiency. Finally, several groups requested that they specifically be entirely exempted from the regulations, including S corporations, foreign banking organizations and other financial organizations, certain real estate groups, and groups that are 100 percent domestic, because they do not generally participate in the "earnings stripping" transactions that Treasury and IRS have cited as the policy reason for the proposed regulations. In addition, commenters requested that certain types of transactions − including foreign-to-foreign loans, post-acquisition integration activities and stock-based compensation − be entirely exempted from the regulations.

Validity

Judkins' testimony focused exclusively on statutory and procedural defects in the proposed regulations, and he urged the government to withdraw the proposed regulations. He noted that (1) the proposed regulations are contrary to the statutory language of section 385 (which provides that the regulations "shall set forth factors"), (2) the automatic recast of valid debt into equity for failing to satisfy the documentation requirements is arbitrary (noting that Congress demonstrated that it knows how to write a strict substantiation requirement when it required documentation for deducting meals and entertainment, but that it did not include a similar requirement in section 385), and (3) the effective date for the *per se* rule is procedurally defective because it is immediately applicable, contrary to the requirements of the Administrative Procedure Act (APA). Although Kevin Nichols disagreed that the *per se* rule was immediately effective because the proposed regulations provide that the debt will not be recharacterized as equity for 90 days, that delay does not cure the core defect − the regulation applies to any debt issued or deemed issued on or after April 4, 2016. As Baker & McKenzie noted in its comment letter, the APA requires a delayed effective date for regulations unless an agency provides that there is "good cause" for an immediate effective date. The good cause exception cannot apply here because Treasury and the IRS did not satisfy its requirements in issuing the proposed regulations.

Part-Stock Rule

The commenters generally expressed concern that the lack of defined factors or guidelines to be applied in determining whether to bifurcate an instrument would lead to significant uncertainty for the appropriate tax treatment of routine transactions and inconsistent determinations by IRS agents during an examination. Requests for improving the final regulations included providing factors that agents should apply in determining whether and how to bifurcate an instrument, as well as a *de minimis* threshold for when an instrument would be bifurcated (for example, if an instrument is at least 80 percent debt, commenters suggested that the entire instrument should be treated as debt).

Documentation Requirements

Commenters criticized the documentation requirements in the proposed regulations as burdensome and impractical. Many commenters discussed the significant up-front costs that taxpayers would be required to incur to develop and maintain systems for documenting and tracking compliance, and dismissed Treasury's economic impact analysis for being unreasonably low. For example, OFII discussed a study that it commissioned from PWC which demonstrated initial system set-up costs of just under $3 million, with compliance costs averaging $1 million annually, for a typical Fortune 100 company. Moreover, OFII and other commenters noted that it would take taxpayers 18-24 months, at a minimum, to implement the necessary systems once the final regulations are issued and taxpayers know what the rules are with which they will actually have to comply. Finally, many commenters explained why the 30-day requirement for preparing documentation was completely unworkable, and requested a more reasonable deadline (such as requiring documentation to be prepared by the due date of the relevant tax return, including extensions).

In addition to criticizing the documentation requirements themselves as burdensome and impractical, the commenters criticized the penalty for failing to satisfy the documentation requirements as overly harsh. Rather than a valid debt instrument automatically being recast as equity merely for failing to satisfy the documentation requirements, commenters recommended that, instead, taxpayers should lose the associated interest deduction or be subject to a monetary fine. Moreover, several commenters noted that the reasonable cause exception included in the proposed regulations was unduly narrow and should be revised.

Per Se Rules

Most of the validity concerns focused on Treasury and IRS's failure to explain the departure in the *per se* rule from the statutory requirement in section 385(b) that the regulations "shall set forth factors" and longstanding judicial precedent that applies a multi-factor analysis in determining whether an instrument is debt or equity. Commenters also questioned what impact the proposed regulations would have on tax treaties and foreign taxes if a reclassification occurred.

In general, there was consensus among the commenters that the final regulations should provide exemptions for cash pooling and short-term loans (which are economically equivalent to cash pools) to allow normal business operations to continue unimpeded. The 72-month presumption was roundly criticized for causing significant uncertainty and compliance burdens, and commenters recommended that it should be shortened to a 24-month period (at most) instead. In addition, commenters recommended that the presumption should be rebuttable. Finally, commenters requested that the ordinary course exception should be expanded and the exception for current E&P should be changed to an exception for accumulated E&P.

Thompson: A Lone Voice in Support of the Proposed Regulations

Thompson was an energetic speaker who praised Treasury and the IRS for “thinking outside the box” when they drafted the proposed regulations, and stridently defended Treasury’s authority in issuing the proposed regulations. For example, he argued that Congress’ use of the word “shall” in section 385(b) (that the regulations “shall set forth factors”) was permissive, and not mandatory. Thompson also suggested that Treasury and the IRS should meet with the Tax Division of the Department of Justice to discuss the regulations, if Treasury and IRS have not already done so. In addition, he suggested a few “improvements” that Treasury and IRS should make when finalizing the regulations, including eliminating the E&P exception in its entirety and extending the documentation requirements to all corporations with more than $100 million in assets. However, even Thompson agreed that the 72-month period was too long and should be carved back to a 24-month testing period.

What’s Next?

Treasury is reviewing the extensive substantive comments that have been submitted on the proposed regulations, and continuing to work on finalizing the proposed regulations. Although several commenters recommended that Treasury withdraw the proposed regulations, that seems unlikely − Treasury has stated publicly that they still intend to finalize the regulations soon. However, Treasury and IRS have been very careful in their public statements to refrain from signaling what they expect the final regulations to contain − other than a promise to “fix” cash pooling, it remains to be seen what changes, if any, Treasury and IRS will make to the final regulations to reflect the comments received. It seems unlikely that Treasury and IRS will be able to review and consider all the comments received by Labor Day, which Commissioner Koskinen had initially suggested was the IRS’s goal for publishing final regulations. Instead, it seems more realistic to expect final regulations later this fall.

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

Brexit Update: Britain Changes Relationship Status to 'It's Complicated'

As might be expected following the decision to end a relationship that lasted for 40 years, after just one month the timing and terms of the break up are yet to be agreed. While European Union leaders begin to formulate their negotiating positions, the following charts some milestones that have passed since June 23, 2016 and comment on the practical considerations for multinational groups.

Theresa May's B(rexit) Team

On July 13, 2016 Theresa May replaced David Cameron as British Prime Minister. Although May supported the Remain campaign, she did so less emphatically than many of her peers. Since taking office, May has confirmed that "Brexit means Brexit and we're going to make a success of it."

With the exception of appointing Philip Hammond (another Remain supporter) as Chancellor of the Exchequer, May adopted a "you Brexit, you own it" policy when selecting the members of her Cabinet that will be influential in Brexit's implementation. Alongside the unveiling of Boris Johnson (former Mayor of London and leader of the Leave campaign) as Foreign Secretary, May also appointed Leave campaigners Liam Fox (as Secretary of State for International Trade) and David Davis (as Secretary of State for Exiting the European Union).

High on the agenda for the UK government will be devising the United Kingdom's priorities for the Brexit negotiations. As yet, there is no consensus among Ministers as to what the most credible post-Brexit scenario for the United Kingdom is. In particular, May's Cabinet is reportedly divided over the trade off between maintaining access to the European Union's Single Market and controlling immigration.

Pulling the Trigger

On July 21, 2016 Irish Taoiseach Edna Kenny and French President Francois Hollande echoed calls for the United Kingdom to activate Article 50, the article in the EU treaty that sets out the formal process for a member state to leave the EU, "as soon as possible." Undeterred, the UK government reiterated that the Brexit negotiations will not commence until early 2017. This stance has been blessed by German Chancellor Angela Merkel, arguably the most powerful continental politician. Following the first bilateral meeting between May and Merkel, Germany's Chancellor commented that it is "understandable that a new government will have to take a moment." However, Merkel confirmed that Germany would not entertain *informal* negotiations prior to Article 50 being invoked. Nonetheless, prior to Article 50 being triggered Britain and the European Union may agree to a code of conduct that sets out ground rules for the Brexit negotiations.

The domestic issues faced by the UK government demonstrate why, notwithstanding the uncertainty generated by the spectre of Brexit, it is prudent for the United Kingdom to resolve its own affairs before engaging with the other European Union Member States.

Constitutional Issues

In an effort to keep the United Kingdom united, Theresa May remarked that Article 50 will not be triggered until the home nations have agreed to “approach and objectives.” In response, Scotland’s First Minister Nicola Sturgeon noted that Scotland (which voted to remain in the European Union by 62 percent to 38 percent) may hold a second independence referendum. Sturgeon added that Scotland may even remain inside the European Union. While there is precedent for a nation having territory inside the European Union while other parts are outside (Denmark is inside, but Greenland, which is part of Denmark, is outside), achieving such an arrangement with Scotland is viewed as problematic. It is clear that this state of affairs affords Scotland influence over the Brexit negotiations. Even if this influence falls short of a veto, Sturgeon believes that Scotland is in a “very strong position.”

Legal Issues

Legal actions have been brought in the High Court to establish whether the UK government can invoke Article 50 without obtaining the approval of Parliament. As these legal challenges are not scheduled to be heard until mid-October (and could be appealed to the Supreme Court), they could influence the timing of the Article 50 notification. Should the UK government lose the argument, it would be required to obtain the approval of the House of Commons and the House of Lords. While it is unlikely that the UK government would be defeated in the House of Commons (at the time of the referendum roughly two thirds of Members of Parliament were in favor of remaining in the European Union, but it is inconceivable that they would overturn the will of 17 million voters), the House of Lords represents a more daunting hurdle, given that its members are unelected and, therefore, less likely to be concerned by public opinion.

Practical Issues

While the balance of power between Downing Street, the Foreign Office and the newly created government departments (the Department for Exiting the European Union and the Department for International Trade) continues to unfold, it is apparent that teams across Britain’s civil service will need to be expanded, to support the analysis and negotiations that Brexit will entail. Moreover, although the Department for International Trade was established with the brief of commencing trade negotiations with non-European Union nations, a recent report identified that Britain has “between 12 and 20 officials…with direct knowledge of trade negotiations.” In contrast, Canada’s Trade Minister recently commented that Canada has 300 trade negotiators. The European Commission is reported to have 600 such employees.

Open for Business

In the wake of the economic turbulence that erupted after the referendum result was announced, the former Chancellor of the Exchequer, George Osborne, announced his intention to cut the corporation tax rate to 15 percent (from the current 20 percent rate) by 2020. Offering a rate of 15 percent would put Britain below that of any other major economy, and considerably below the average rate of Organisation for Economic Co-operation and Development (“OECD”) nations, which is 25 percent.

Osborne's plans were not met with universal acclaim. Pascal Saint-Amans (Director of the OECD's Centre for Tax Policy and Administration) commented that Brexit "may push the UK to be even more aggressive" and that the continuation of such steps could "turn the UK into a tax haven type of economy." Osborne's plans were also criticized by the French and German Finance Ministers.

Osborne's successor as Chancellor of the Exchequer, Philip Hammond, has refused to confirm whether he will deliver on his predecessor's plans. Hammond did, however, comment that Britain may 'reset' fiscal policy if economic data worsens (potentially as early as Autumn 2016). In any event, it is evident that taxation policy could be part of H.M. Treasury's long term economic strategy. Against the backdrop of European Union initiatives (such as the Anti-Tax Avoidance Directive, state aid investigations, exchange of tax authority rulings, public country-by-country reporting, and the Common Consolidated Corporate Tax Base) the United Kingdom could seek to position itself as an attractive jurisdiction for doing business.

Practical Considerations

It is upon the cessation of the United Kingdom's European Union membership that any significant legal consequences of Brexit will come into effect. Liam Fox (Secretary of State for International Trade) has identified January 1, 2019 as the provisional date for Brexit (although there is considerable scope for this to change).

With the possible legal consequences of Brexit in mind, many multinational groups have begun evaluating the extent to which Brexit could impact their operations. Much of the uncertainty faced by multinational groups is a product of the fact that it is unclear if the United Kingdom will continue to be bound by European Union law and benefit from agreements concluded between the European Union and third countries.

While there are numerous options for the United Kingdom's post-Brexit trading relationships with the European Union and the rest of the world, the different models are merely possibilities. Indeed, there is a growing school of thought that Britain may not replicate the Norwegian, Swiss or Turkish models, and that instead a comprehensive free trade agreement may be negotiated between the United Kingdom and the European Union.

In the event that Brexit occurs without the United Kingdom having trade agreements in place, the United Kingdom would default to the World Trade Organization rules. This would entail the United Kingdom imposing tariffs on imports and surcharges being levied on British exports. Trade in services could be restricted.

Although there are several alternatives for how the United Kingdom may (or may not) continue to be bound or influenced by European Union legislation, what the final outcome will be is currently unknown. As such, many multinational groups with United Kingdom operations are undertaking audits of their business and identifying areas that are restricted or supported by European Union law. The typical approach is to identify the business impact of an exit from the EU without any new agreements being in place at that time. This enables groups to take a clear position on the critical elements of any new arrangements that Britain might enter into. In addition to identifying risks to the business, this approach also brings clarity to the business' messages to the UK Government as the Brexit process unfolds.

Specific to tax, any multinational groups that have European Union entities rely on the Interest and Royalties Directive and the Parent-Subsidiary Directive to eliminate withholding tax on interest, royalties and dividends paid between related parties in the European Union. Although the United Kingdom maintains an extensive network of double taxation agreements, it is not comprehensive. For example, the double taxation agreement between the United Kingdom and Germany does not eliminate dividend withholding tax. As it is yet to be established whether the United Kingdom will continue to benefit from these directives post-Brexit, many multinational groups are assessing whether relevant intra-group payment flows could be exposed to withholding tax. While this exercise may encourage multinational groups to consider reorganizations, recent developments (notably, OECD work regarding treaty shopping, and the introduction of beneficial ownership and anti-avoidance rules) may make this less straightforward.

By James A.D. Wilson and Philip Thomas, New York/London

OECD Releases Draft Guidance on Attribution of Profits to Permanent Establishments

On July 4, 2016, the OECD released a discussion draft of *Additional Guidance on the Attribution of Profits to Permanent Establishments* (the "2016 Draft"). Prior to the 2016 Draft, the OECD had published a final Report on Action 7 of the BEPS Action Plan, *Preventing the Artificial Avoidance of Permanent Establishment Status* (the "2015 Report on Action 7"), which, among other things, lowered the existence threshold for deemed permanent establishments ("PE") and modified the specific activity exceptions from PE status for fixed places of business which is backed up by an anti-fragmentation rule. As a result of the conclusions in the 2015 Report on Action 7, the triggering threshold of PE in Article 5 of the OECD model tax treaty ("MTC") was modified to capture not only situations where true dependent agents may execute contracts on behalf of and with authority from a nonresident enterprise, but also de facto agents which conclude contracts which are accepted by nonresident enterprises with no or merely immaterial modification. In addition, the OECD added a requirement that fixed places of business must serve a preparatory or auxiliary function to a nonresident enterprise as a whole in order to avoid PE status. This requirement may not be circumvented by fragmenting an otherwise non-preparatory or auxiliary fixed place of business.

Although the OECD in accordance with its 2015 Report on Action 7 has made the PE threshold more sensitive in Article 5 of the MTC, once that threshold is crossed, the definition of what precisely the scope of that PE is has not been affected. The OECD states in the 2016 Draft that identifying the scope of a PE before and after implementation of BEPS Action 7 has not changed in substance and, therefore, the standard tools used to attribute profits should apply all the same. Nevertheless, the OECD has identified two classes of deemed PEs for which it has solicited comments about how best to attribute profits: (1) Dependent Agent Permanent Establishments ("DAPE") and (2) warehouses, indicating a willingness to evolve or possibly concede with respect to its views on attribution.

Currently, the OECD supports and the 2016 Draft is meant to build upon the so-called Authorized OECD Approach ("AOA") to attribution of profits to PEs. This is the approach espoused in the OECD *2010 Report on the Attribution of Profits to Permanent Establishments*. The AOA has at its core two axioms:

(1) PEs should be treated as theoretically separate and distinct from the principal nonresident enterprise.

(2) Assets and risks should be attributed between the PE and the principal nonresident enterprise in a manner consistent with the "significant people functions."

The AOA is not particularly widely accepted and many countries follow their own methods for the attribution of profits, often resembling or outright copying their respective transfer pricing regimes. This has created concern that opportunities for BEPS will remain following the implementation of BEPS Action 7.

Through the examples and the solicitation of comments, the 2016 Draft attempts to clarify the relationship between Article 7 of the MTC, dealing with "Business Profits," and Article 9 of the MTC, which focuses on "Associated Enterprises" and transfer pricing principles, to establish consistent results and ensure that BEPS and double taxation are avoided.

Dependent Agent Permanent Establishments

An enterprise which does not have a fixed place of business may nevertheless have a PE in a source jurisdiction when a dependent agent present in the source jurisdiction contracts on behalf of the enterprise. Where a DAPE is involved, there is a question of how much of the profit of a given transaction ought to fairly be attributed to the DAPE and how much ought to be attributed to the dependent agent itself. What may complicate the equation even more is when the dependent agent which generates the DAPE is a dependent associated enterprise ("DAE"). In such a case, the transfer pricing rules must also be invoked to determine an appropriate allocation between the nonresident enterprise and the DAE. At first blush, this may appear to complicate the issue of attribution and pose a risk of conflation of the transfer pricing rules, the AOA to profit attribution, and the timing of the two. However, the OECD asserts that the most reasonable method would be to square away the transaction between the nonresident enterprise and the DAE first under the transfer pricing rules as that would solve the problem of attributing profits to and compensating the dependent agent for the value of the services the dependent agent rendered, leaving the homogenous equation of attributing profits between the DAPE and the nonresident enterprise to be solved.

The 2016 Draft presents four examples of DAPEs and how under the AOA and transfer pricing rules the profits ought to be attributed. We give a summary of the four examples and invite you to view the details in the 2016 Draft.

Example 1: The nonresident enterprise acts as principal and engages an associated enterprise which is resident in the source jurisdiction. The activities of the associated enterprise are presumed to generate a DAPE. This example analyzes the attribution of profits under the AOA guidelines as well as the transfer pricing rules of Article 9. Ultimately, however, since there are no significant people functions performed in the source country by the DAPE, no profits are attributed to the DAPE.

Example 2: This example is quite similar to the example above, however, here the DAPE is allocated more of the risk which is shifted away from the nonresident enterprise. Because of the increased allocation of risk to the DAPE, e.g. the DAPE is responsible for managing the inventory, controls customer credit, and collections, relative to the original example, it has increased its significant people functions which results in an increased attribution of profits.

Example 3: This example is quite similar to the example above, except here the nonresident enterprise sends an employee to perform the activities the DAE performed originally. As there is no DAE, Article 9 of the MTC does not apply in this example. The employee is responsible for managing the inventory, controls customer credit, and collections. Relative to the original example, it performs significant people functions in the source jurisdiction which results in an increased attribution of profits to the DAPE above and beyond the employee's salary.

Example 4: Here, both the nonresident enterprise and the dependent agent perform activities related to extended credit to customers. This example shows the potential consequences of the overlap in the profit attribution approach and the transfer pricing rules.

Warehouse PEs

The preparatory or auxiliary qualification was added to the MTC specific activity exemptions from PE status because, over time, activities which were implicitly of a preparatory or auxiliary nature had become core business activities. For example, a warehousing business that provides services to third parties may no longer be considered preparatory or auxiliary.

The 2016 Draft provides an example of a fixed place PE/warehouse with three scenarios and attributes profits between the nonresident enterprise and the fixed place PE. The nonresident enterprise uses a warehouse solely for the purpose of storage, display, or delivery of goods or merchandise which does not qualify as preparatory or auxiliary to the overall business activity of the enterprise.

Example 5(A) - Warehousing as the core business: A nonresident enterprise resident in Country A operates a warehouse in Country W where it stores inventory solely for third parties. Here, the profits in the PE essentially reflect the reward for the economic ownership of the warehouse and the routine functions performed at the warehouse, since all the significant people functions and related risk are performed by the nonresident enterprise's head office.

Example 5(B) - Warehousing as an internal function of the business: This scenario is the same as 5(A) above, except the nonresident enterprise is engaged in the sale of goods to third parties and uses the warehouse in Country W to store its inventory. Like the first example, the profits in the PE essentially reflect the reward for the economic ownership of the warehouse and the routine functions performed at the warehouses, since all the significant people functions and related risk are performed by the nonresident enterprise's head office. Here, however, in the absence of third-party income to calculate profits of the PE, the example attributes profits to the PE commensurate with investment in the asset, taking into account appropriate funding costs, compensation for investment advice, and the performance of routine functions at the warehouse.

Example 5(C): The facts are the same as in 5(B) above, except the nonresident enterprise contracts with a third-party warehouse manager located in Country W to run the warehouse. The profits in the PE solely reflect the reward for the economic ownership of the warehouse and none of the risk assumed by the warehouse manager have affect on the profits attributed to the PE.

In summation, the attribution of profits between nonresident enterprises and their resident PEs is still very much an open problem. There is no consensus among nations, and most do not subscribe to the AOA. Thus, the OECD has requested comments with regard to the 2016 Draft and how it may be improved to harmonize the PE profit attribution and transfer pricing regimes, and minimize administrative costs where a DAPE exists under the post-BEPS Article 5 and would otherwise be required to file a return but is attributed no profits under Article 7. Comments may be sent in the form of a Word document by September 5, 2016 addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA at TransferPricing@oecd.org.

By Sean J. Tevel and Keith Hagan, Miami

OECD Issues Discussion Draft on Profit Splits and Conforming Amendments to Transfer Pricing Guidelines

On July 4, 2016, the Organisation for Economic Co-operation and Development (“OECD”) released a discussion draft on profit splits in connection with Actions 8-10 (assure that transfer pricing outcomes are in line with value creation) of the joint OECD-G20 Action Plan on Base Erosion and Profit Shifting (BEPS).

The recent discussion draft does not liberalize the use of profit splits; rather, the discussion draft provides guidance to assist practitioners in determining if the profit split method is the most appropriate based on the facts and circumstances of the transaction. Further, the July 4, 2016 discussion draft more narrowly defines the use of profit splits as compared to the December 19, 2014 OECD document titled “BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains.” (The December 2014 document addressed nine scenarios where one could argue that it might be difficult to apply one-sided transfer pricing methods to benchmark the arm’s-length range, and for which a profit split might therefore be appropriate.)

Similar to the current 2010 version of the OECD Transfer Pricing Guidelines (“OECD Guidelines”), the July 4, 2016 discussion draft notes that profit splits may be appropriate when the parties share in “economically significant risks.” The discussion draft explains that profit splits would not be appropriate for entities with operational integration typical for associated enterprises. In the case of “synergies alone,” the discussion draft stresses that there is no need to apply the profit split method; instead, the discussion draft maintains that synergies can be addressed by allocating the benefit among the parties in proportion to their contributions in a manner analogous to the allocation of service costs.

The beginning of the discussion draft draws a distinction between: (i) combining and splitting anticipated profits; and (ii) combining and splitting actual profits. Profit splits based on projected profits use projections to set the pricing for a transaction (for example, when projections are used to determine the arm’s-length royalty rate). The discussion draft notes that since there is no adjustment of the pricing based on actual results under this approach, the sharing of risk between the parties is limited. In contrast, the discussion draft contends that splitting actual profits exposes each party to certain risks controlled by the other; hence splitting actual profits would only be appropriate when both parties share economically significant risks (for example, from operational integration and/or making contributions to a valuable intangible).

The discussion draft makes the distinction that a profit split may be more appropriate when there is parallel integration (multiple entities contribute at the same stage in the value chain – e.g., via intangible contributions or joint development or marketing efforts) as compared to instances of sequential integration (entities perform discrete functions). The discussion draft argues that in the case of sequential integration, companies are likely better able to find reliable benchmarks for each entity (since each entity performs a unique function).

The discussion draft discusses two types of profit splits: contribution analyses and residual analyses, both of which can be applied either to actual profits or projected profits. A residual analysis requires that each party first receive a return on its routine functions, usually using the transactional net margin method. Any remaining profit is then allocated to the parties in proportion to assets contributed or risk-weighted costs.

The discussion draft stresses the importance of performing a value chain analysis to understand if the profit split method is appropriate. The value chain analysis includes identifying and understanding the following: (i) key value drivers in relation to the transaction; (ii) the nature of the contributions of assets, functions, and risks to the value drivers; (iii) which parties can protect and retain value through performance of important functions; (iv) which parties assume economically significant risks or perform control functions relating to the economically significant risks associated with value creation; and (v) how parties operate in combination in the value chain, and share functions and assets in parallel integration.

Transfer pricing practitioners have expressed varying ideas about what constitutes a value chain analysis. Some practitioners (considering the description of the value chain analysis described above) believe the value chain analysis is simply the traditional functional analysis (as set forth in current transfer pricing documentation), with perhaps a greater focus on risk. Others think that the value chain analysis may be a different exercise altogether – perhaps focusing on ascribing value to all the different functions performed by the consolidated group.

Comments on the discussion draft are due by September 5, 2016.

Conforming Amendments to Chapter IX of the OECD Guidelines

On July 4, 2016 the OECD released Conforming Amendments to Chapter IX (Transfer Pricing Aspects of Business Restructurings) of the OECD Guidelines. Once comments are received, the conformed version of Chapter IX will replace the current 2010 version in a consolidated version of the OECD Guidelines. The conforming amendments are needed due to changes to the OEDC Guidelines proposed in the 2015 BEPS Reports related to (i) Actions 8-10, “Aligning Transfer Pricing Outcomes with Value Creation,” and (ii) Action 13, “Transfer Pricing Documentation and Country-by-Country Reporting.” The changes to Chapter IX are intended to (i) fix inconsistencies between the existing Chapter IX and the final BEPS proposals and (ii) remove duplication. Review of the amendments is invited. However, they caution that this review should not be used to comment on aspects of the OECD Guidelines that have been changed due the BEPS project, but only to confirm that inconsistencies with the revised parts of the OECD Guidelines have been addressed, and duplication appropriately removed.

Comments on the Conforming Amendments were due August 16, 2016.

By Jessie L. Coleman, Washington, DC

IRS Finalizes Regulations Allowing Outside Counsel to Conduct Summons Interviews

On July 14, 2016, the IRS published final regulations (T.D. 9778) under Code Section 7602. These final regulations “clarify” that IRS and Office of Chief Counsel contractors, “such as outside economists, engineers, consultants, or attorneys – may receive books, papers, records, or other data summoned by the IRS and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a person who the IRS has summoned as a witness to provide testimony under oath.”

The Final Regulations

T.D. 9778 added a new subparagraph (3) to Treas. Reg. § 1.7602-1(b), and provides as follows:

> **Participation of a person described in section 6103(n)**. For purposes of this paragraph (b), a person authorized to receive returns or return information under section 6103(n) and § 301.6103(n)-1(a) of the regulations may receive and review books, papers, records, or other data produced in compliance with a summons and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of a witness summoned by the IRS to provide testimony under oath. Fully participating in an interview includes, but is not limited to, receipt, review, and use of summoned books, papers, records, or other data; being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person’s representative to clarify an objection or assertion of privilege.

These final regulations apply to summons interviews conducted on or after July 14, 2016.

The Back Story

The process giving rise to these final regulations began approximately two years ago, with the IRS's June 18, 2014, publication of temporary regulations and cross-referencing proposed regulations under section 7602. These temporary and proposed regulations were not reflected on the Treasury/IRS Priority Guidance Plan, and in contrast to the final regulations, made no mention of attorneys as being among the class of outside contractors that could participate in summons interviews. The proposed regulations elicited only one comment before the comment period closed, and no hearing was held.

This seeming lack of interest evaporated when it was revealed that the IRS was relying upon the temporary regulations to permit attorneys from the law firm Quinn Emanuel Urquhart & Sullivan, LLP to question witnesses in summons interviews. This revelation drew a strong rebuke from Senate Finance Committee Chairman Orrin G. Hatch (R-Utah) in a May 13, 2015 letter to IRS Commissioner John Koskinen. This revelation also drew expressed concern from Federal District Court Judge Ricardo Martinez, who was "troubled by Quinn Emanuel's level of involvement . . . [t]he idea that the IRS can 'farm out' legal assistance to a private law firm is by no means established by prior practice, and this case may lead to further scrutiny by Congress."

Nevertheless, Treasury and the IRS finalized the proposed regulations, without any meaningful changes. Indeed, the only change to the regulatory text is the substitution of the word "examine" with "review" in the phrase describing what contractors may do with books, papers, records or other data received by the IRS under a summons.

What Happens Next?

On July 12, 2016, two days before the final regulations were published, Chairman Hatch introduced the Taxpayer Protection Act of 2016 (S. 3156), which was marked up by the Senate Finance Committee on April 20, 2016. If enacted into law, S. 3156 would preclude the IRS from delegating authority under section 7602 to contractors, thereby effectively overturning the final regulations. While Treasury and IRS claim in the preamble to the final regulations that they are <u>not</u> delegating section 7602 authority to contractors by permitting them to question witnesses in summons interviews, that characterization is contradicted by the rule itself, which authorizes contractors to perform tasks under section 7602 that they could not perform in the absence of the rule.

The negative outpouring following the revelation of Quinn Emanuel's involvement in summons interviews may have tempered the IRS's ambitions to deputize outside counsel again in the future, regardless of whether S. 3156 is enacted. IRS Chief Counsel William Wilkins has publicly stated that the IRS has no present intention to hire additional outside law firms, and while this is far from a guarantee, it indicates that the IRS likely will exercise caution before using the final regulations as a tool to permit outside lawyers to perform functions that have historically been performed by the IRS and its Chief Counsel lawyers.

By Daniel A. Rosen, New York

IRS Issues New Proposed Deferred Compensation Regulations, Foreshadowing Future Areas for Guidance

On June 21, 2016, the IRS issued proposed regulations ("Proposed Regulations") to clarify or modify various aspects of the current Code Section 409A regulations, as well as the proposed section 409A calculation regulations. The Proposed Regulations make only marginal changes to the section 409A regime. They may be most interesting for what they forecast in terms of the next pieces of deferred compensation guidance that can be expected, rather than for the substance of what was actually done in the Proposed Regulations. Below, we outline the more significant changes made in the Proposed Regulations, as well as what the regulations suggest about the next waves of section 409A and other deferred compensation guidance.

As a reminder, section 409A was enacted in 2004 and put in place strict rules governing deferred compensation. Deferred compensation generally is compensation that may be paid more than a short period of time after it is earned and vested. Deferred compensation can only be paid based on certain events and schedules set forth at the time the right to the deferred compensation is awarded, and the payment event or schedule may be changed only in limited circumstances. Failure to comply with section 409A (for example, by making a payment earlier or later than scheduled), results in income to the employee at the time the amount is vested, rather than when actually paid. In addition, the income taxed at vesting is subject to penalty taxes (a 20 percent tax on top of regular rates, plus an interest charge tax).

Highlights of Changes Made in Proposed Section 409A Regulations

Definition of a Payment

The Proposed Regulations add for the first time a definition of when a payment is made that applies across the section 409A regulations. Under Prop. Reg. § 1.409A-1(q), a payment is made for all purposes under section 409A when a taxable benefit is actually or constructively received, including when (i) cash is transferred, (ii) property is transferred and taxable under Code Section 83, or (iii) there is income under the economic benefits doctrine, Code Section 402(b), or Code Section 457(f). A payment is also treated as having been made when deferred compensation is exchanged for non-taxable benefits, such excludable health insurance or excludable fringe benefits.

Flexibility for Payment Timing upon Death

The Proposed Regulations made two significant changes to the rules allowing a payment to be made on death. The final section 409A regulations already allow considerable flexibility to pay out on death even when the plan does not provide for such a payment. The first change made in the Proposed Regulations in the death context is to allow similar flexibility in the event of the death of a beneficiary. In other words, the Proposed Regulations would allow on the death of a beneficiary the same flexibility to pay deferred compensation that is already allowed on the death of the employee.

The second change made in the death context is to allow a longer period to pay in the event of death without violating section 409A. The general rule in the final section 409A regulations is that, if a payment is set for a specified schedule or on a specified event (death, disability, termination of employment, etc.), the payment is treated as timely made if it is made by the end of the year of the scheduled date or the event or, if later, within 2 1/2 months following the specified event. The Proposed Regulations acknowledge that payments on death can often take longer due to the need to locate the correct beneficiary, etc. Accordingly, the Proposed Regulations allow a payment triggered by death to be made by the end of the calendar year following the year in which the death occurs, and still be treated as paid in a timely manner compliant with section 409A.

Additional Exception to Short-Term Deferral Rule

Under the short-term deferral rule, an award such as a restricted stock unit is exempt from section 409A if it is settled within 2 1/2 months following the end of the later of the employer or employee's tax year in which the award vests (i.e., by March 15 if employee and employer are both calendar year taxpayers). Current rules provide certain narrow exceptions that will allow for payment after this short-term deferral period without violating section 409A. The proposed rules create an additional exception, which is available if the issuer reasonably anticipates that making the payment would violate "Federal securities laws or other applicable law," provided that the payment is made as soon as practicable once the risk of such violation no longer applies.

Permissible Delayed Cash-Out of Options and SARs in Connection with Transactions

Under the current section 409A regulations, deferred compensation subject to section 409A that is tied to the value of the employer's stock can generally be paid on the same schedule and terms that the transaction consideration is paid to shareholders in connection with a change in control. This is helpful where part of the purchase price due to shareholders of an acquired company in a change of control is deferred pursuant to an earn-out provision or is subject to an indemnification hold-back. The proposed rules confirm that the ability to delay payment in certain change of control transactions also applies to the payment of exempt stock options and stock appreciation rights (together, "stock rights") that are "cashed out" in connection with a transaction.

Grants to Prospective Employees

Due to the definition of "eligible issuer of service recipient stock" under the current section 409A regulations, stock rights granted to prospective employees that are effective prior to commencement of employment would not be exempt from section 409A. The Proposed Regulations modify this definition, with the result that it will be possible to grant stock rights that are exempt from section 409A to individuals before they commence employment, provided that it is reasonably anticipated that the individual will begin providing services, and the individual actually does begin providing services, within 12 months after the date of grant.

Ability to Include "Bad Boy" Provisions in Exempt Stock Rights

Under the current section 409A regulations, a stock right is not exempt from section 409A if any permanent repurchase obligation or call right that applies to the underlying stock is based on a measure other than fair market value.

However, in order to deter behavior that can hurt the employer, repurchase provisions often provide for the repurchase price to be based on the lesser of fair market value and the original purchase price where the employee is terminated for cause or violated company policy. In response to these concerns, the Proposed Regulations relax this rule and allow the repurchase price for shares subject to stock rights to be based on a measure other than fair market value in situations where the employee is terminated for cause or violates a non-compete or confidentiality provision (or other similar circumstance).

Interplay with Proposed Regulations Under Section 457(F)

On the same date that the Proposed Regulations were issued, the IRS released separate proposed regulations governing section 457(f), which applies to nonqualified, unfunded deferred compensation arrangements established by state and local governments and other tax-exempt organizations. The section 457(f) regulations have been awaited with eagerness by private employers due to the fact that section 457(f) contains similar terms and definitions as section 409A and the guidance under section 457(f) was viewed as potentially relevant to section 409A. For example, section 409A and section 457(f) both contain an exemption for bona fide vacation leave plans. The proposed section 457(f) regulations indicate that a plan is a bona fide vacation pay plan exempt from section 457(f) if the facts and circumstances show its primary purpose is to provide participants with paid time off from work for sickness, vacation or other personal reasons. Factors to be considered include the amount of leave provided and whether it could reasonably be used by employees, ability to cash-in leave, and the ability to accumulate and carry over leave and then exchange the leave for cash. It would be reasonable to expect that the same factors will be relevant to a determination whether a vacation pay program is exempt from section 409A.

Next Waves of Deferred Compensation Guidance

As mentioned, the Proposed Regulations serve as a reminder that the IRS has been promising two additional sets of guidance once the Proposed Regulations are issued.

Section 409A Calculations Regulations

The Proposed Regulations made a change to the section 409A calculation regulations to address a perceived abuse in how the IRS understands taxpayers are applying the regulations. As background, a deferred compensation plan that is not compliant with section 409A can be corrected without penalty in the year before participants become vested in the deferred compensation. The calculation regulations are proposed to be clarified to provide that section 409A income inclusion and penalties are not avoided (and the participants will be treated as vested and taxable for section 409A purposes) if plan payment terms are changed other than consistent with a reasonable, good faith determination that the change is required to make the deferred compensation compliant with section 409A.

The IRS focus on the section 409A calculation regulations is a reminder that those regulations are likely to be finalized in the near future. This is alarming because those regulations are extraordinarily complicated and burdensome in application, and make no attempt to provide for a streamlined method for employers to report section 409A income and penalty taxes. As background, section 409A states generally that, where there is noncompliance with section

409A, the deferred compensation will be included in income (and subject to penalty tax) when it is no longer subject to a substantial risk of forfeiture. The proposed calculation regulations generally call for income inclusion based on the value of the deferred compensation as of the end of the year of vesting. Where the value of the deferred compensation goes up over time, additional incremental amounts are required to be included in income each year thereafter (and taxed at section 409A penalty tax rates) until the deferred compensation is paid out.

The calculation regulations generally focus on income inclusion, and the calculation of penalty taxes, to the recipient of the deferred compensation. Thus, the regulations and the examples consider the issue largely from the employee's perspective. Under the regulations, if an employee has section 409A income that should have been included in income in a year now closed by the statute of limitations, the income is required to be taken into account in the first open year. However, the employer's obligations to report the income is left somewhat unclear. It is not clear if the employer is obligated to amend Forms W-2 and report the income for the year in which the deferred compensation became vested, whether or not those years are open for the employer under the statute of limitations. Moreover, if the Form W-2 reporting of the income is required to occur in the employee's first open year, it is unclear how the employer would know the details of the employee's income tax situation in order to determine which is the most recent open year. Since very few comments were submitted on the proposed calculation regulations, and only one suggested a streamlined approach for employer reporting of section 409A income, employers can expect the current confusing and burdensome section 409A calculations regulations to be finalized as proposed unless additional comments are submitted.

Section 457A

The Proposed Regulations also remind us that Code Section 457A exists and that the IRS might next consider proposing regulations under section 457A. The proposed regulations contain a few clarifications meant to coordinate section 409A with section 457A, which was enacted after the section 409A final regulations were issued. Section 457A makes a participant in a deferred compensation arrangement taxable at vesting, rather than at receipt of payment, if that deferred compensation is sponsored by a "nonqualified entity." A nonqualified entity generally is a foreign entity that the United States views as not subject to a comprehensive income tax. Under section 457A, a foreign entity is not a nonqualified entity if it is eligible for the benefits of a comprehensive income tax treaty with the United States or can otherwise demonstrate to the Secretary of Treasury that it is subject to a comprehensive income tax regime. The only guidance issued by the IRS to date on section 457A is Notice 2009-8. Under Notice 2009-8, Q&A 8, a foreign corporation also is treated as a nonqualified entity if it is taxed in its country of residence under a favorable regime or has significant income in that country that is not taxable (such as dividends from a subsidiary). These tests are extremely difficult to apply in practice, and have made compliance with section 457A very difficult for employers who have a globally mobile workforce. To the extent these tests are included in proposed regulations in the future, taxpayers should comment on them and seek a more administrable set of standards for determining when section 457A applies.

By Anne G. Batter, Washington, DC and members of the Executive Compensation and Employee Benefits Group from the North American Compensation and Employment Law Practice

European Union Update: Disclosure of Ultimate Beneficial Owners

As part of the fourth European Union (EU) anti-money laundering directive (AMLD), adopted by the European Parliament last year, all Member States of the EU are obliged to set up an ultimate beneficial owners register by June 26, 2017. The goal of setting up the registers of ultimate beneficial owners is to increase transparency, making it more difficult to hide shadowy deals and to prevent money laundering, tax evasion and terrorist financing. The main aspect of the new register of ultimate beneficial owners is that it concerns a <u>public</u> register identifying ultimate beneficial owners of legal entities and trusts.

Definition of an Ultimate Beneficial Owner

An (ultimate) beneficial owner means any natural person(s) who ultimately owns or controls the 'customer' and/or the natural person(s) on who's behalf a transaction or activity is conducted and includes at least:

A. In the case of legal entities:

(i) The natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership of a significant percentage of the shares or voting rights or ownership interest including though bearing (or bearer) shareholdings or through control via other means, other then a company listed at a regulated market that is subject to disclosed requirements consistent with European Union law or subject to equivalent international standards which ensure adequate transparency of ownership confirmation.

A shareholding of 25 percent plus one share or a ownership interest of more than 25 percent in the 'customer' held by a natural person shall be an indication of direct ownership.

A shareholding of 25 percent plus one share or an ownership interest of more than 25 percent in the 'customer' held by a corporate entity which is under the control of a natural person(s) or by multiple corporate entities, which are under control of the same natural person(s), shall be an indication of indirect ownership.

Member States may decide that a lower percentage may be an indication of ownership of control.

(ii) if, after having exhausted all possible means and provided there are no grounds for suspicion, no person under point (i) is identified, or if there is any doubt that the person(s) identified, are the beneficial owner(s), the natural person(s) who holds the position of senior managing official(s) are in principle registered as ultimate beneficial owners.

B. In the case of trusts:

(i) the settlor;

(ii) the trustee or trustees;

(iii) the protector, if any;

(iv) the beneficiaries, or where the individuals benefitting from the legal arrangement or entity have yet to be determined, the class of persons in who's main interest the legal arrangement or entity is set up or operates;

(v) any other natural person exercising ultimate control over the trust by means of direct or indirect ownership or by other means.

C. In the case of legal entities, such as foundations and legal arrangements similar to trusts, the natural person(s) holding equivalent or similar positions to those referred to in point B.

Accessible Information

It is important for every ultimate beneficial owner to understand what kind of information can be accessed by parties that consult the register. Especially so, since the companies themselves are responsible for providing this information. The following details of the ultimate beneficial owner will be available to all parties:

- name;
- month and year of birth;
- nationality;
- country of residence; and
- nature and extent of the beneficial interest.

Furthermore, the relevant competent authorities and EU financial intelligence agencies, but also obliged entities such as banks, notaries and lawyers, for know your client purposes, and members of the public having a legitimate interest, may have access to the following additional information:

- day, place and country of birth;
- current address;
- citizen service number;
- type, identifying number, date and place of issuance of the document used to verify the identity of the ultimate beneficial owner; and
- all the relevant documents that prove the beneficial ownership of the ultimate beneficial owner, i.e., the shareholders' register, deeds of share transfer and similar documents.

Closing Remarks

For the Member States, the next steps are consulting all parties concerned and preparing a draft legislative proposal. Since the deadline for implementing the register of ultimate beneficial owners into the national laws of the Member State is within one year, the final outcome in each Member State is expected in due course. We anticipate significant news in this area and flag it as an area to watch given the potentially widespread impact.

By Alexander R. Spoor and Frits Burg (Corporate Practice), Amsterdam

State and Local Tax Update

Delaware Unclaimed Property Litigation Update

The Delaware Department of Finance's (the "Department") unclaimed property enforcement practices continue to undergo challenges in state and federal courts through claims involving both companies and other states. The following is brief overview of the latest developments in a few noteworthy cases:

Temple-Inland

In *Temple-Inland, Inc. v. Cook,* 1:14-cv-00654 (D. Del., filed May 21, 2014), the US District Court for the District of Delaware declared some of the Delaware Department of Finance's controversial unclaimed property enforcement practices to be unconstitutional executive action that "shocks the conscience." See our July 14, 2016 North America Tax Client Alert *Federal District Court Holds Delaware's Unclaimed Property Enforcement Practices "Shock the Conscience"* available under insights at www.bakermckenzie.com.

Open questions remained following the District Court's order, including the remedy for Delaware's substantive due process violations and disposition of Temple-Inland, Inc.'s ("Temple-Inland") takings clause claim. However, on August 5, 2016, through a Joint Motion to Dismiss with Prejudice, the parties agreed to settle the case. While this likely is the end of the *Temple-Inland* saga, the District Court's opinion stands and will provide valuable support for companies challenging Delaware unclaimed property audits. There are also indications that the Department is considering changes to its unclaimed property enforcement practices in response to the *Temple-Inland* opinion − Delaware's Secretary of Finance, Thomas Cook, informally stated that officials are "conducting a thorough review of the state's escheat statutes, regulations, policies and procedures, with the intention of improving the program going forward." However, it remains to be seen what − if any − changes will be made. In the meantime, the Department's audit practices will continue to be challenged. For example, a case filed by Office Depot in July raises many of the same issues that were central to *Temple-Inland*. See *Office Depot, Inc. v. Cook*, 1:16-cv-00609 (D. Del., filed July 18, 2016).

Plains All American Pipeline

In addition to *Temple-Inland*, another Delaware unclaimed property case involving similar constitutional arguments has likely reached its end. On August 16, 2016, the US District Court for the District of Delaware dismissed the plaintiff's case in *Plains All American Pipeline, L.P. v. Cook*, No. 1:15-cv-00468 (D. Del., filed June 5, 2015). In that case, Plains All American Pipeline, L.P. ("Plains") filed a pre-emptive suit in the District Court, seeking, in part, an injunction against continuation of an audit authorized by Delaware and conducted by Kelmar Associates, LLC ("Kelmar"), the Department's primary contract auditor.

The District Court's dismissal of Plains' case was not due to the merits of the company's constitutional arguments. Rather, the court held that the company lacked standing to sue Kelmar and that most of Plain's constitutional claims were not yet ripe. The practical implication of the *Plains* dismissal is that before bringing a judicial challenge to Delaware's unclaimed property enforcement practices, a company will either need to wait for an audit to be completed and exhaust available administrative remedies, or force the state to engage in a formal enforcement action, such as issuing a subpoena. Whether the Department has the authority to enforce such a subpoena in the first instance is currently being litigated in Delaware's Chancery Court. See *Department of Finance v. Blackhawk Engagement Solutions (DE), Inc.*, No. 11737-CB (Del. Ch., filed Nov. 20, 2015).

MoneyGram

Unclaimed property holders are not the only ones protesting Delaware's unclaimed property enforcement practices. In *Delaware v. Pennsylvania*, No. 22O145 ORG (U.S., filed May 31, 2016), and two other almost identical cases, nearly half of US states have alleged Delaware circumvented federal law by escheating up to $400 million in uncashed checks issued by MoneyGram Payment Systems Inc. ("MoneyGram").

MoneyGram, one of the largest money transfer companies in the world, regularly escheated uncashed checks to Delaware, its state of incorporation. However, other states have now asserted that the state where the checks were purchased are exclusively entitled to escheat the uncashed checks in accordance with federal law. With multiple states claiming jurisdiction over the same property, the nation's highest court is now being asked to provide clarity on competing state positions.

By Matthew S. Mock and David Andrew Hemmings, Chicago

Massachusetts Appeals Court Ignores Federal Closing Agreement in Recharacterizing Debt

The Appeals Court of Massachusetts ("Court") recently upheld the Massachusetts Appellate Tax Board's ("Board") decision that certain financing transactions between affiliates resulted in equity, as opposed to debt. *Nat'l Grid Holdings, Inc. v. Com'r of Rev*., Mass. App. Ct., No. 14-P-1662 (6/8/16). In a companion case, the Court further held that a closing agreement with the Internal Revenue Service ("IRS") that permitted some of the taxpayer's interest deductions claimed in connection with the aforementioned intercompany financing was <u>not</u> binding on the Massachusetts Department of Revenue ("Department") because the closing agreement "did not establish that the [transaction] qualified as interest." *Nat'l Grid USA Service Co., Inc. v. Comm'r of Rev.*, 89 Mass. App. Ct. 522 (6/8/16). These cases provide additional clarity in determining whether debt will be treated as equity in Massachusetts and also provide insight into Massachusetts's position surrounding the acceptance of IRS closing agreements.

Three US subsidiaries of National Grid plc (collectively "Taxpayers") entered into several financing transactions, referred to as deferred subscription agreements ("DSAs"), to allegedly "take advantage of the differences between US and UK tax codes." The Court focused on the transaction between National Grid Holdings, Inc. ("NGHI") and its UK affiliate, National Grid Eight Limited ("NG8"). NG8 was created as part of an intercompany refinancing and the NG8 DSA was designed to reflect NGHI's $2.68 billion of third party debt. NGHI purchased 10 million shares of NG8 for $2.695 billion, with an initial payment of $15 million and three additional payments, referred to as call payments, which NGHI was to pay on or after certain agreed-upon call dates. After purchasing the shares of NG8, NGHI sold those shares to National Grid (US) Investments 4 ("NGUSI4") for $2.695 billion. NGHI used the proceeds from the sale, totaling $2.68 billion ($2.695 billion minus $15 million), to pay its outstanding third-party debt.

The NGHI DSA provided that NG8 could make calls on NGHI for its payments on or after specified dates. The first three payments represented interest and the last payment represented principal plus interest. The NGHI DSA further provided that if NGHI failed to make payment within seven days of NG8's call, NGUSI4 was "entitled to serve a notice" on NGHI requiring NGHI to repurchase the NG8 shares.

NGHI treated the call payments as debt, deducting the interest on such payments from its Massachusetts taxable income. Similarly, NGHI treated the call payments as debt for purposes of calculating its Massachusetts taxable net worth. The Department argued that the NGHI DSA did not carry an unqualified obligation for repayment since NGUSI4's service of notice to repurchase was discretionary (i.e., the Department argued that there was no actual obligation for NGHI to ever repurchase the NG8 shares if NGUSI4 never served notice to repurchase). It is worth noting that NGUSI4 did not serve notice to repurchase shares as all of the applicable calls and call payments were made prior to the default dates. Furthermore, the Department argued that the NGHI DSA was structured for purposes of exploiting international tax arbitrage – that NGHI was treating the transaction as debt for Massachusetts tax purposes, but as equity for UK tax purposes (noting that the UK strictly prohibits debt issued by a nonresident subsidiary). As such, the Department denied NGHI's interest deductions and recalculated its taxable net worth by disallowing deductions claimed for the debt in such computation. The Board agreed with the Department's findings.

Unqualified Obligation to Repay

The Court stated that the legal standard for defining debt is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof," citing *Overnite Transp. Co. v. Comm'r of Rev.*, 764 N.E.2d 363 (Mass. 2002), *quoting Gilbert v. Comm'r of Int. Rev.*, 248 F.2d 399 (2d Cir. 1957). Using this standard, the Court analyzed the NGHI DSA to determine whether the repurchase of NG8 shares was mandatory to determine whether the transaction constituted debt or equity. Looking first at the language of the contracts that governed the NGHI DSA, the Court found nothing that unambiguously mandated NGUSI4's service of notice to NGHI to repurchase the NG8 shares in the event the call payment was not honored.

The Court also reviewed the expert testimony on the obligation to repay. Central to the expert testimony from both sides was the intent behind the creation of the NGHI DSA to avoid the appearance of debt in the UK. In the UK, a debenture between a UK entity and its foreign subsidiary is statutorily prohibited, but the financing transaction must constitute true debt to qualify for the interest deduction in Massachusetts. Thus, the Court stated that NGHI and NG8 sought to structure the NGHI DSA to constitute equity for UK purposes and debt for US purposes. To accomplish this, the "transactions were deliberately designed with indeterminate dates and methods of payment, and with amounts due only upon notice given, and in the form of an asset repurchase rather than repayment." In an effort to create equity for UK purposes, the Court noted, the Taxpayers failed to create true debt for US purposes in its financing transactions. Accordingly, the Court denied the interest deductions related to the NGHI DSA.

Recharacterizing the NGHI DSA as equity also implicated the Taxpayers' Massachusetts taxable net worth, as it was no longer a liability deductible from total assets. The Court was not persuaded by the Taxpayers' argument that its net worth assessment should be consistent with how the Taxpayer actually accounted for the liability on its books. The Court determined that if the NGHI DSA did not constitute debt for purposes of deducting interest in the determination of corporate excise tax, it did not constitute debt for calculating taxable net worth.

Federal Closing Agreement

The Taxpayers sought to introduce a closing agreement with the IRS that included a final determination approving of NGHI's interest deductions. The Board determined that the IRS closing agreement was inadmissible because it was the "settlement of a claim," which was inadmissible to prove liability or the amount of a claim, citing *Morea v. Cosco, Inc.*, 664 N.E.2d 822 (Mass. 1996).

In a companion case, National Grid US Service Co. ("NGUSA"), one of the Taxpayers maintained that the IRS's allowance of a portion of the interest deduction in a closing agreement for federal income tax purposes should constitute the allowance of a deduction for Massachusetts corporate income tax purposes. *See Nat'l Grid USA Service Co., Inc. v. Comm'r of Rev.*, 89 Mass. App. Ct. 522 (6/8/16). The Court held otherwise, agreeing with the Board that "permitting only some of the claimed Federal interest deductions…, and not all, the closing agreement did not establish that the …payments qualified as interest."

It is worth noting that *Nat'l Grid USA Service Co., Inc.* is a separate appeal than *Nat'l Grid Holdings, Inc.* because Taxpayers filed a second amended return to report the Federal changes that resulted from the IRS closing agreement three months after filing its original amended return. The Department did not act on the second amended return. Additionally, the Court in *Nat'l Grid Holdings, Inc.* denied Taxpayers' request to introduce the closing agreement into evidence, discussed above, and Taxpayers filed a subsequent appeal for the federal closing agreement issue.

While the *Nat'l Grid Holdings, Inc.* decision is important for obtaining additional clarity on how the Department analyzes debt versus equity for purposes of calculating interest deductions, *Nat'l Grid USA Service Co., Inc.* may be equally or even more important in that it puts taxpayers on notice that the Department appears unwilling to consider federal closing agreements in the determination of Massachusetts corporate excise tax and net worth. Thus, the major takeaways from these cases are: (1) for debt-equity purposes, an unqualified obligation to repay is essential to treat a financial transaction as debt; and (2) taxpayers may not be able to rely on the federal income tax treatment pursuant to a federal closing agreement for purposes of determining Massachusetts taxable income.

Please note that on June 28, 2016, the Taxpayers appealed the decisions in *Nat'l Grid Holdings, Inc.* and *Nat'l Grid USA Service Co., Inc.* to the Massachusetts Supreme Court. The Department's responses were due July 22, 2016. We are awaiting decisions.

By Theodore R. Bots, Chicago, David Pope and Trevor R. Mauck, New York

. . . And Justice for One Michigan MTC Litigant (For One Year, Maybe). . .

Bringing a semblance of order to the prior proceedings, the Michigan Court of Appeals reversed the Michigan Court of Claims ruling that defied the remand instructions from the Michigan Supreme Court. *International Business Machines Corp. v. Dep't of Treasury*, Dkt. 327359 (Mich. Ct. App. July 21, 2016). The appellate court's ruling would result in granting to International Business Machines Corp. ("IBM") a total of nearly $6 million in Michigan Business Tax ("MBT") refunds for the company's 2008 tax year.

Two years earlier, the Michigan Supreme Court held IBM was entitled to elect the Multistate Tax Compact's ("MTC" or the "Compact") evenly-weighted, three-factor apportionment formula using property, payroll and sales instead of the single-sales factor apportionment formula provided by the MBT for tax year ending 2008. *International Business Machines Corp. v. Dep't of Treasury*, 852 N.W.2d 865 (Mich. July 14, 2014). In an attempt to limit the impact of the Michigan Supreme Court's decision in *IBM*, the legislature retroactively repealed the MTC Compact in its entirety, including the MTC election, effective January 1, 2008 (Public Act 282 of 2014, effective September 12, 2014). Following the enactment of Public Act 282, the Michigan Supreme Court denied the Michigan Department of Treasury's ("Department") motion for reconsideration and remanded the case to the Court of Claims for a ministerial 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 an express order to grant summary disposition in favor of IBM, the Court of Claims denied IBM's motion for summary disposition and instead granted the Department's motion for reconsideration, finding that Public Act 282 precluded IBM's claim. *International Business Machines Corp. v. Dep't of Treasury*, Dkt. 11-000033-MT (Mich. Ct. Cl. 2015). That is, the Court of Claims, in effect, overruled the Supreme Court.

This rather surprising turn of events was rationalized by the Court of Claims finding that ". . . the Michigan Supreme Court's mere denial of rehearing does not show that the issue of PA 282 was actually decided. The law of the case doctrine [whereby a ruling by an appellate court on a particular issue binds the appellate court and all lower tribunals with respect to that issue] does not apply to the Supreme Court's order." The Court of Claims concluded that the retroactive effect of Public Act 282 precluded IBM "from claiming a refund premised on the Compact's elective apportionment formula." This unexpected development, elevating the legislative branch's subsequent actions above the highest state court's decision that was based on an interpretation of legislative intent, raised fundamental questions about separation of powers and the ability of a lower court to disregard the order issued by a higher appellate court.

The Court of Appeals has now figuratively set the record straight, clarifying it is improper for a lower court to disregard a higher court's order and specific instructions, and reversing the Court of Claims decision. The Court of Appeals held:

> [T]he Court of Claims did not have any discretion or authority to rule in favor of the Department. The Court of Claims was specifically instructed to enter an order granting summary disposition in favor of IBM, and it erred by ultimately failing to do so.

Additionally, the Court of Appeals found that the law of the case doctrine was not applicable, holding that "the principle. . . that a lower court cannot exceed the scope of a remand order controls and is distinguishable from the law of the case doctrine." The Court of Appeals instead relied upon the "rule of mandate" which is "similar to, but broader than, the law of the case doctrine." That rule "embodies the well-accepted principle in our jurisprudence that a lower court must strictly comply with, and may not exceed the scope of, a remand order."

The Court of Appeals found that the Court of Claims improperly exceeded the limit of its powers on remand and that "[f]or all intents and purposes, the [*IBM*] case was over once it left the Michigan Supreme Court; there was not to be any further substantive litigation, proceedings, or decision-making." The Court of Appeals also clarified its position that Public Act 282, which was enacted following the issuance of the Supreme Court's opinion and prior to rendering a decision on the Department's motion for rehearing, could not change the decision, noting that "it is well-established that 'the Legislature may not reverse a judicial decision,' and that 'only the Supreme Court has the authority to overrule its own decisions.'" Thus, the Court of Appeals held that neither the state legislature nor the Court of Claims had the power to alter the Michigan Supreme Court's ruling.

. . . But Still Not Justice for All

Although it ruled in favor of IBM, the Court of Appeals made clear that its ruling only applies to IBM for its 2008 tax year and not to any other taxpayers or any subsequent tax years, distinguishing the present case from its recent ruling in *Gillette Commercial Operations N.A.& Subsidiaries, et al. v. Dep't of Treasury*, 312 Mich. App. 394 (2015), *cert denied* Dkt. 152588 (Mich. June 24, 2016). In *Gillette*, the Court of Appeals upheld the retroactive repeal of the Compact in Public Act 282 and denied those corporate taxpayers the ability to make the Compact election. The Court of Appeals explained that its *Gillette* decision could not overrule or reverse the Michigan Supreme Court's decision in *IBM*, which related to IBM's 2008 MBT liability; however, this decision did not protect IBM or other taxpayers from the effect of Public Act 282 with respect to other taxes not addressed in *IBM*, regardless of the fact that most of the claims in the *Gillette* case were filed before the Michigan Supreme Court's resolution in *IBM* and "prudently held […] in abeyance pending that decision." In other words, with the exception of IBM's 2008 tax year, Public Act 282 applied instead of the Michigan Supreme Court's decision in IBM, denying the use of the Compact election for those taxpayers and periods.

Taxpayers have brought Compact election cases in a number of states, with the California Supreme Court and Minnesota Supreme Court ruling in favor of the state and with appeals to the Oregon Supreme Court and Texas Supreme Court pending. Some of the California litigants have petitioned the U.S. Supreme Court for review, and the Michigan litigants from *Gillette* are reportedly planning to file a petition with the U.S. Supreme Court later this year. While the final disposition of the Compact election cases remains to be seen and the Department still could appeal in *IBM*, we are pleased to report that in Michigan, at the time of the writing of this article, IBM appears to have received the favorable judgment granted to it by the Michigan Supreme Court in 2014.

For previous updates on the MTC three-factor apportionment election debate, please refer to prior *Tax News and Developments* articles *California Shaves Off its MTC Refund Claims for the New Year* (Volume XVI, Issue 1, February 2016), *Multistate Tax Compact Litigation: 3-Factor Apportionment Election Update* (Volume XV, Issue 5, October 2015), *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), and *Ready for Another Round? Michigan's Second Retroactive Repeal of the Multistate Tax Compact Election* (Volume XIV, Issue 6, December 2014) available under insights at www.bakermckenzie.com.

By John Paek, Palo Alto and David Andrew Hemmings, Chicago

Canadian Tax Update

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

Draft Legislation to Implement 2016 Canadian Federal Budget Proposals

The Canadian Department of Finance ("Finance") released draft legislation for public comment (the "Draft Legislation") on July 29, 2016 to implement a number of the proposed measures from the 2016 Canadian federal budget, which were described in the *Canadian Tax Update* of our April 2016 edition of *Tax News and Developments* Volume XVI-2 (the "April Newsletter"), available under insights at www.bakermckenzie.com. The following is a summary of the Draft Legislation that may be of interest to multinationals with Canadian operations.

Cross-Border Surplus Stripping

The Draft Legislation includes proposals to strengthen the "anti-surplus stripping" rules found in the Canadian *Income Tax Act* (the "ITA"). The anti-surplus stripping rules may apply where a non-resident corporation disposes of shares of a Canadian corporation to a non-arm's length Canadian corporation. These rules prevent the non-resident vendor from extracting amounts from the transferee in excess of the "paid up capital" ("PUC") of the shares of the transferred corporation on a tax-free basis. The proposed amendments are effective March 1, 2016.

Extension of the Back-to-Back Rules

The "back-to-back loan" rules in the ITA prevent taxpayers from interposing a third party between a Canadian borrower and a foreign lender in order to reduce the amount of Canadian withholding tax that would otherwise apply. The Draft Legislation extends the application of the back-to-back rules in four situations, each of which are discussed in greater detail in the April Newsletter:

- **Back-To-Back Rules for Rents, Royalties and Similar Payments:** The ITA generally imposes a 25 percent withholding tax on rents, royalties or similar payments made by a resident of Canada to a non-resident, which may be reduced or eliminated by an income tax treaty. Where a taxpayer pays or credits an amount that is a rent, royalty or similar payment to an intermediary in a treaty country having a lower withholding rate than what would have been payable if it was made directly to the ultimate non-resident payee, the new rules in the Draft Legislation operate to deem the payment to have been made directly to the ultimate non-resident payee. The proposed amendments apply after 2016.

- **Character Substitution Rules:** The character substitution rules in the Draft Legislation address back-to-back arrangements in respect of which the back-to-back rules would not otherwise apply because one or more of the arrangements is not a lease, license or similar agreement. For example, where shares or debt are used as part of aback-to-back rent or royalty arrangement. The proposed amendments apply after 2016.

- **Back-To-Back Shareholder Loan Arrangements:** Where a corporation makes a loan to an arm's length person on the condition that the person makes a loan to a shareholder of the corporation, the corporation is deemed pursuant to the Draft Legislation to have made a loan to the shareholder. The proposed amendments apply for loans received after March 21, 2016.

- **Multiple Intermediary Arrangements:** The Draft Legislation amends the existing back-to-back loan rules to clarify the manner in which they apply to arrangements that include two or more intermediaries.

Base Erosion and Profit Shifting ("BEPS")

The Draft Legislation includes measures to adopt recommendations from the Organisation for Economic Co-operation and Development's (the "OECD's") package of recommendations to address BEPS released on October 5, 2015.

- **Country-by-Country Reporting ("CbC"):** The Draft Legislation includes measures to implement CbC reporting for taxation years beginning on or after January 1, 2016. OECD BEPS recommendations include a minimum standard for CbC reporting. The Draft Legislation for CbC reporting largely follows the OECD's draft legislation released on October 5, 2015, and applies to multinational enterprises having total annual consolidated revenue of €750 million or more. A CbC report will have to be filed with the Canada Revenue Agency (the "CRA") by the ultimate parent entity that is resident in Canada within 12 months of the end of the fiscal year to which the report relates. A surrogate parent entity that is not the ultimate parent entity may file the CbC report provided certain requirements are met.

- **The Common Reporting Standard ("CRS") Penalty and Consequential Amendments:** On April 15, 2016, Finance released proposals to implement the CRS developed by the OECD. In connection with these proposals to implement the CRS, the Draft Legislation requires a reportable person to provide its taxpayer identification number ("TIN") upon request to any person required to make an information return requiring a TIN. The Draft Legislation includes a penalty of CAD$500 for failing to provide a TIN.

Eligible Capital Property ("ECP")

ECP generally includes goodwill and other intangible property having an indefinite life, such as indefinite life licences, franchises and copyrights. The Draft Legislation includes measures to repeal the current ECP regime and replace it with a new class of depreciable property, effective January 1, 2017, subject to extensive transitional rules for existing ECP.

By Lesley Kim and Randall Schwartz, Toronto

Draft Legislation to Revamp the GST/HST Drop Shipment Rules

The Department of Finance released draft legislative and regulatory proposals on July 22, 2016 relating to the goods and services tax/harmonized sales tax ("GST/HST") that touched on a number of areas including the treatment of pension plans and businesses that make supplies of financial services. The most important proposals for non-residents of Canada are amendments relating to the application of the drop shipment rules. It appears that the purpose of the amendments is to clarify the application of the rules and ensure that the policy intent behind the rules is achieved. This is noteworthy as many have considered the CRA to have taken an overly restrictive approach in interpreting the existing drop shipment rules, for instance, their application to lease transactions.

The drop shipment rules have two purposes, which are as follows:

- the drop shipment rules allow a non-resident of Canada who is not registered for GST/HST purposes to acquire in Canada goods, or commercial services in respect of goods, on a tax-free basis, provided the goods are ultimately exported, or are retained in Canada by a GST/HST registrant that agrees to accept a potential liability for tax in respect of a subsequent transfer of non-commercial use of the goods.

- the drop shipment rules help ensure that GST/HST applies to goods located in Canada that are supplied by an unregistered non-resident person for final consumption in Canada in the same way as tax would apply if the goods were acquired from an unregistered non-resident person out of Canada and imported for final consumption in Canada.

The most common application of the drop shipment rules involve situations where unregistered non-resident vendors acquire goods in Canada from Canadian GST/HST registered suppliers and arrange to have the supplier transfer physical possession of the goods to a third person (typically the non-resident's customer) in Canada.

Among the amendments proposed in the draft proposals are the following:

- clarification that where the situation involves the provision of commercial services by a registrant to an unregistered non-resident person, the drop shipment rules only apply where the commercial services are performed in Canada;

- clarification that the drop shipment rules apply to goods used as inputs in the manufacture of other goods or a commercial services in respect of other goods for the unregistered non-resident purchaser or another unregistered non-resident person;

- introduction of the concept of "owner's certificates" that allow the drop shipment rule relieving provisions to apply where the consignee of the goods is a person other than the direct purchaser of a supply from an unregistered non-resident supplier; and
- introduction of new rules to clarify the application of the drop shipment rules to ensure the same result in lease transactions irrespective of whether the particular goods are leased or purchased from a Canadian supplier or an unregistered non-resident.

The drop shipment rules are one of the more complex areas of the GST/HST legislation and the draft proposals add to that complexity. In this vein, it is interesting to note that the amendments will become effective at different times. Certain amendments will become effective as of the July 22, 2016 Announcement Date (or in certain specific cases before that date) while others will become effective on the day the amendments to the *Excise Tax Act* (Canada) receive Royal Assent. The Department of Finance is inviting stakeholders to submit comments regarding the proposed amendments by August 31, 2016.

By Lesley Kim and Randall Schwartz, Toronto

Final US Regulations on Country-by-Country Reporting Issued

On June 29, 2016, Treasury and the IRS released final regulations (the "Final Regulations") requiring US multinational groups with at least $850 million in annual global revenues to prepare and file country-by-country ("CbC") reports for tax years beginning on or after June 30, 2016. The reports must be filed with the annual tax return on new Form 8975 (not yet released), and will contain information on worldwide revenues and profits, taxes paid, employees, assets, stated capital and other information, by jurisdiction. The Final Regulations closely conform with the CbC reporting recommendations of the joint OECD-G20 Base Erosion and Profit Shifting ("BEPS") project.

For a full discussion of the Final Regulations, please see previously released Tax Client Alert, *Final US Regulations on Country-by-Country Reporting Implement OECD BEPS Action 13 for US Multinationals*, distributed on July 20, 2016, and available under insights at www.bakermckenzie.com. The Client Alert provides a detailed description of the Final Regulations, along with an analysis of the international environment surrounding CbC reporting and the issues and challenges ahead for the US Treasury, IRS and taxpayers as these regulations are implemented.

IRS Releases Proposed New QI Agreement to Be Effective January 1, 2017

On July 1, 2016, the IRS proposed the terms of the new Qualified Intermediary Agreement ("QIA") in its Notice 2016-42. The IRS has requested comments to the proposed new QIA by August 31, 2016. Once finalized, the new QIA will be effective with respect to all qualified intermediaries ("QIs") on or after January 1, 2017, following the expiration of the current QIA at the end of 2016. The new QIA will expire with respect to QIs at the end of the third full calendar year it is in effect.

The proposed new QIA contains a number of expected changes from the 2014 QIA, particularly with respect to additional provisions permitting a QI that is an eligible entity to act as a qualified derivatives dealer ("QDD"). Further areas of change include procedures for periodic review and certifications of compliance, the joint account or agency option for certain partnerships or trusts and treaty claims issues.

Current and prospective QIs should carefully review the terms of the proposed new QIA and begin now to take steps to adjust their compliance review and reporting procedures in light with the new requirements. QIs that receive payments of substitute dividends in 871(m) transactions should consider qualification as a QDD to prevent the application of cascading withholding based on the new QDD terms. All QIs and prospective QIs should take steps to synchronize their FATCA compliance to the new QI requirements and should begin implementing procedures for the new documentation requirements for treaty limitation on benefits claims.

For a full discussion of the new QIA, please see previously released Global Tax Client Alert, *IRS Releases Proposed New Q1 Agreement to be Effective 1 January 2017*, distributed on July 8, 2016 and also available under insights on www.bakermckenzie.com. For a copy of the Proposed QIA, please refer to IRS Notice 2016-42, available at https://www.irs.gov/pub/irs-drop/n-16-42.pdf.

2704 Proposed Regulations Released: Further Valuation Restrictions Imposed

Section 2704 is part of the Special Valuation Rules meant to address the planning tool of the "estate freeze." An estate freeze is a technique that attempts to limit or reduce the value of an interest in a business or other property for estate tax purposes. In many cases, this is accomplished by having the older generation transfer the appreciating interest in a business to the younger generation while retaining a non-appreciating interest. The Treasury Department recently released the anticipated Proposed Treasury Regulations under Code Section 2704, providing clarification and imposing further limitations on the use of valuation discounts for transfers of interests in family controlled entities for transfer tax purposes. The Proposed Regulations address Entities Covered and Classifications, Lapse of Voting or Liquidation Rights and Death Bed Transfers, Elimination of Discounts on Transfers to Assignees, Ability to Liquidate, Disregard of "Applicable Restrictions," and New Disregarded Restrictions. As currently drafted, any final regulations will become effective with respect to "lapsing voting and liquidation rights" and transfers subject to "applicable restrictions" that occur on or after the date of publication of the final regulations. With respect to transfers subject to newly defined "disregarded restrictions," the final regulations will become effective 30 days following the date of publication of the final regulations. If enacted in their current form, the Proposed Regulations would essentially eliminate discounts for minority control and lack of marketability in transfer tax valuations of interests in closely held entities (e.g. family limited partnerships, closely held corporations, and other family controlled entities).

For a full discussion of the proposed regulations, please see previously released Client Alert, *Impact on Business Valuations of Lapsed Rights and Restrictions on Liquidation of an Interest: Is This the End of Valuation Discounting As We Know It? Section 2704 Proposed Regulations Released*, distributed on August 18, 2016 and available under insights at www.bakermckenzie.com.

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Adjusting for the Future: New UK Transfer Pricing Rules Could Affect Finance and Royalty Structures

The United Kingdom recently proposed a "secondary adjustment rule" to cancel out any advantage arising from a transfer pricing adjustment in excess of £1 million. A transfer pricing "primary" adjustment for a non-arm's length price only takes effect for tax purposes, so if for example a UKCo pays its overseas subsidiary a royalty of £10m that is adjusted down to £8m, the UKCo's tax liability increases, but the overseas subsidiary retains the £2m, which stays outside the UK tax net.

The secondary adjustment, if introduced, would treat the £2m as a deemed loan from UKCo to its subsidiary, with the imputed interested being taxable. The deemed loan starts at the end of the accounting period in which the correct primary adjustment is made, and ceases when the funds are repatriated to the United Kingdom.

If introduced, the proposed rules are not likely to take effect until 2017 or 2018. However, the change could have a retrospective effect and apply to deemed loans "arising" in all accounting periods where there is an open enquiry, or the window has not yet closed.

For a full discussion of the rule and its impact, please see previously released Global Tax Client Alert, *Adjusting for the Future: New Transfer Pricing Rules Could Affect Finance and Royalty Structures*, distributed in August 2016 and available under insights at www.bakermckenzie.com.

Mexican Tax Developments - Reporting Obligations

A recent tax amendment to the Mexican Administrative Guidelines ("Miscelanea Fiscal") would affect, from a reporting perspective, the current standing of a number of off-shore structures held by Mexican residents. Mexican residents maintaining any kind of off-shore investment in blacklisted jurisdictions or through fiscally transparent entities through 2016 are required by the amendment to report their participation in these structures by filing the informative return in February 2017. Mexican residents are required to file this return, regardless of whether they retain or have relinquished control over the off-shore investment and does not automatically trigger the application of the Preferential Tax Regime Rules (PTR) regarding the income inclusion on accrual basis.

For a full discussion of the amendment, including relevant exception rules regarding the application of PTR, please see previously released Latin America Tax Client Alert, *Mexican Tax Developments - Reporting Obligations*, distributed August 9, 2016 and available at http://bakerxchange.com/rv/ff00299a3bd73d7679d415de9248a07b65fb7d75.

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Getting Better All the Time…US Tax Planning Capabilities Widen with New York Addition

Baker & McKenzie is pleased to announce the arrival of **Patrick M. Cox** as tax partner to our New York office. With nearly 20 years of experience in developing effective tax strategies for multinational companies, Patrick has a diverse background in tax planning, advising clients in corporate, partnership, international and real estate taxation.

Focusing his practice on the tax aspects of cross-border mergers and acquisitions, corporate reorganizations, and debt offerings and exchanges, Patrick has assisted several multinational companies in global restructurings of their capital structure and rationalization of their operations. A well-rounded practitioner in various areas of tax planning, Patrick provides insight to private equity funds, hedge funds and other investors navigating US income tax law and US income tax treaties that relate to securities (debt and equity), real estate, and other operating assets, bolstering the growing New York tax practice group and adding to the expansion of the Firm's tax planning practice on the east coast. "As new tax legislation continues to change the tax planning arena, it is exciting to join a Firm where I can continue to develop and expand my practice, assisting in cross-border and domestic business transactions, as well as augment the Firm's bankruptcy tax practice," said Patrick.

Most recently, Patrick obtained an eight-figure tax refund for a client relating to the tax treatment of securities holdings in the context of a complicated cross-border restructuring organizing a foreign investment structure. He frequently contributes as an author to several journal articles and is a frequent speaker on international tax planning topics throughout the community. Patrick received his law degree from Hofstra University, an LL.M. in Tax from New York University School of Law and obtained his undergraduate degrees from the University of California at Berkeley.

We are excited to welcome Patrick to the North America Tax Practice and look forward to sharing the breadth of his practice to our many clients across the region!

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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 Marie E. Caylor at 312-861-8303 or marie.caylor@bakermckenzie.com.

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