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Tax News and Developments
North America Tax Practice Group

Newsletter

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Back to School: Congress Returns to Work After August Recess

After several weeks at home, Congress returned to work on Tuesday, September 5. An ambitious to-do list awaited them: authorizing funding to respond to Hurricanes Harvey and Irma, increasing the federal debt limit (which the Treasury Department anticipates the US will reach in late September or early October), funding the government, passing a federal budget by the end of the government's fiscal year on September 30 (including reconciliation instructions allowing Republicans to pursue tax reform with only Republican votes), immigration reform, overturning the Affordable Care Act, and reauthorizing expiring legislation, such as that funding the Federal Aviation Administration and the Children's Health Insurance Program (CHIP). These tasks could have easily consumed Congress' attention for the entire month of September.

However, in a moment of bipartisanship, President Trump negotiated a deal with Senate Minority Leader Schumer and House Minority Leader Pelosi to partially fund the response to Hurricane Harvey, increase the federal debt limit through the end of the year, and funding the government through the end of December. The legislation passed on September 8, and it potentially sets up a challenging fall and winter work period as Congress processes tax reform and faces these new deadlines.

President Trump added to Congress' workload on August 30 when he gave his *first major speech* in support of tax reform that is "pro-growth, pro-jobs, pro-worker and pro-American." The speech was high-level and contained no specifics (by design—the President expects the tax-writing committees to develop the specifics of tax reform through the usual legislative process). In his speech, the President identified the following principles for tax reform:

1. The tax code should be simple, fair, and easy to understand.
2. The tax code should be competitive, which means creating more jobs and higher wages for Americans.
3. Reform should include tax relief for middle-class families.
4. Reform should allow companies to bring back trillions of dollars that are "parked" overseas.

As many Democrats and other observers noted, these principles are the same talking points that Congress has used to explain the need for tax reform for several years. So, what's changed that would allow Congress to convert these talking points into legislative reality?

Upcoming Tax Events

18th Annual International Tax and Trust Training Program

Coral Gables, FL
► October 19-20, 2017

Doing Business Globally in the Digital Age

Chicago, IL
► November 7, 2017

Dallas, TX
► November 9, 2017

40th Annual North America Tax Conference

Dallas, TX
► January 25, 2018

19th Annual Latin America Tax Conference

Miami, FL
► February 26-27, 2018

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

The Senate Finance Committee and the House Ways & Means Committee plan to work on tax reform this fall. Chairman Hatch has committed that the Senate Finance Committee will hold several hearings on tax reform and a mark-up this fall (the first hearings began the week of September 11). Readers should pay close attention to these hearings as they occur and be prepared to comment on proposals quickly once they are introduced.

Even though the Big Six (Treasury Secretary Mnuchin, National Economic Council Director Cohen, Senate Majority Leader McConnell, Chairman Hatch, House Speaker Ryan, and Chairman Brady) have announced that tax reform will be enacted by the end of 2017, that deadline could slip in light of the crowded legislative calendar and December deadlines. In contrast to the secretive process that Congress used to draft the health care bill, Congressional leadership has pledged to use “regular order” for tax reform—which means that legislation will originate and be subject to a mark-up in the tax-writing committees and then be presented to the full House and Senate for a vote. Regular order can be a time-consuming process—particularly here, where there is no draft bill for Congress to begin working on when it returned from recess. It’s not even clear that Congressional Republicans and the White House are on the same page on key questions that must be answered to draft legislation, including:

- Should tax reform be permanent, or should Congress focus its efforts on passing temporary tax cuts?
- What should the business tax rate be? Should corporations and pass-through businesses be subject to the same rate?
- Which “special interest” provisions should be eliminated to pay for lowering the tax rate?
- Should interest be deductible, or should Congress sharply limit interest deductibility in favor of allowing full and immediate expensing?
- How should a mandatory repatriation provision be structured (i.e., what is the rate, is it bifurcated for cash and non-cash assets, what is the measuring date, and are foreign tax credits allowed)?
- Should the US have a territorial system and, if so, how should it be structured?

Given the significance of and the likely difficulty in coming to agreement on appropriate answers to these questions, it may be challenging for Congress to pass such legislation by the end of 2017. It is possible that Congress could make significant progress on answering these questions in 2017 that would allow Congress to pass comprehensive tax reform at a later date.

Another option is to enact tax cuts, which would likely be temporary (because Democrats have announced that they will not vote for a tax bill that increases the deficit and cuts taxes for wealthy individuals and businesses, leaving the reconciliation process as Congress’ only option for passing a bill). While drafting and passing legislation that cuts taxes is much simpler than drafting and passing comprehensive tax reform, Congressional leadership still has a few months to decide whether this is its only viable option for enacting legislation.

Finally, the Treasury Department continues to execute the President's regulatory agenda. Treasury is currently reviewing the comments received on the regulations that it identified in Notice 2017-38 that either impose undue burdens or complexity and is expected to issue its final report to the President by the end of September identifying the actions it will take to mitigate the burdens imposed by the regulations listed in Notice 2017-38.

Readers should be prepared to react swiftly to any concrete tax reform proposals issued by Congress but should not lose sight of Treasury's actions to implement current law. This Administration has demonstrated a willingness to listen to taxpayers' concerns that could result in reductions in regulatory burden and complexity that provide immediate benefits to taxpayers while taxpayers wait for the longer-term benefits of comprehensive tax reform.

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

Eaton v. Commissioner - Another Taxpayer Victory in Transfer Pricing Cases

On July 26, 2017, the Tax Court issued its decision in *Eaton v. Commissioner*, T.C. Memo 2017-147, concluding that the IRS abused its discretion in cancelling Eaton's two unilateral Advance Pricing Agreements ("APAs"). The APAs established intercompany pricing for, *inter alia*, breaker products (*e.g.,* circuit breakers, switches, and push button controls) between Eaton and its subsidiary manufacturing plants in the Dominican Republic and Puerto Rico (the "Island Subsidiaries") for years 2001-2005 ("APA I") and 2006-2010 ("APA II"). Both APAs relied on a transfer pricing method ("TPM") that applied a modified comparable uncontrolled price ("CUP") method to price the breakers in a way that guaranteed Eaton Electrical, Inc. ("EEI"), the US distributor and a Delaware corporation, a Berry ratio return (*i.e.*, gross profit as a percentage of operating expenses). Calculation and implementation of the TPM relied on constructed income statements to determine the income stream related to the US distribution function, making EEI the tested party.

For the period covered by the APAs, EEI bought breaker products from the Island Subsidiaries and distributed the breaker products to affiliates in the United States for incorporation into assembled final products. EEI was both distributing breakers within the Eaton group and also selling breakers into the after-market through distributors and other original equipment manufacturers. During negotiation of the APAs, Eaton and the IRS agreed on the creation of a constructed income statement for EEI's distribution function and to test EEI's results against the Berry ratio return.

Adjustment from the IRS

After a lengthy audit, the IRS concluded that Eaton's APAs should be cancelled retroactively, and issued a Notice of Deficiencies for 2005 and 2006 tax years to adjust the pricing of the intercompany transactions between EEI and the Island Subsidiaries. In this regard, the IRS alleged that Eaton negotiated the APAs in bad faith and that Eaton made errors in implementation. Specifically, the IRS argued that Eaton withheld information during negotiations over the APAs, that Eaton's annual reports were incomplete, that the company's TPM was too complex, and that Eaton did not have adequate fiscal controls in place. Eaton contested the deficiency determinations, contending the IRS abused its discretion in cancelling the two APAs.

The IRS position at trial was that EEI should have been earning the Berry ratio return, not just on the distribution function within EEI, but on all EEI activities. Notably, EEI claimed losses in 2005 and 2006 because the US assembly and manufacturing function was not profitable. The IRS had anticipated seeing small but guaranteed profits on the US return; instead the returns reflected losses, while the Island Subsidiaries were profitable.

The IRS sought to apply the comparable profits method (CPM), using the Island Subsidiaries as the tested parties. The effect of the IRS methodology was to allocate 95% of the profit to EEI and 5% to the Island Subsidiaries. The IRS approach to profit allocation was roughly the inverse of Eaton's return position which left roughly 80% of the profits in the Island Subsidiaries and 20% in the United States.

Cancellation of APAs - Standard of Review

Earlier in the life of the controversy, in 2013, the Tax Court sided with the IRS over the appropriate standard of review for the cancellation of an APA. *Eaton Corp. & Subs. v. Commissioner*, 140 T.C. 410, 417 (2013). According to the Tax Court, APAs, like letter rulings, are administrative determinations. Therefore, the standard of review is an abuse of discretion, and taxpayer bears the burden of proof of showing that the IRS's act of canceling an APA is arbitrary, capricious, or without sound basis in fact. Whether the IRS abused its discretion in a given case is a question of fact.

Eaton argued that the IRS abused its discretion in cancelling the APAs. Eaton also argued that the transfer pricing adjustments made by the IRS were not arm's length and that the TPM agreed to in the APAs created arm's length results.

The Tax Court never reached the transfer pricing issue *per se* because it found the IRS abused its discretion in cancelling the APAs. Cancellation of an APA should be done only when there are valid reasons that are consistent with the revenue procedures which set forth rules for cancelling or revoking an APA. The Tax Court found that the IRS did not follow its own revenue procedures, specifically Rev. Proc. 96-53, 1996-2 C.B. 375 (governing APA I) and Rev. Proc. 2004-40, 2004-2 C.B. 50 (governing APA II) with respect to omissions, mistakes, or misrepresentations of a material fact. For any fact to be material, it would have needed to result in a significantly different APA or result in no APA at all. Since the TPM was the essential part of the APA, a material fact must have an impact on the TPM.

In finding that the IRS abused its discretion, the Tax Court reasoned that Eaton negotiated the APAs in good faith, as Eaton responded to all of the IRS's questions and turned over all requested materials. Regarding the alleged omissions, the Tax Court held that the taxpayer is not required to provide information it reasonably believes is unnecessary where the IRS does not ask for it. With respect to misrepresentations during negotiations, the Tax Court applied the following standard: a misrepresentation must be false and misleading with intent to deceive, and it must relate to the APA. Based on the evidence of the negotiations presented at trial, there were no grounds for cancellation of Eaton's APAs. Eaton made a variety of data errors in implementing the TPM, but the Tax Court found that these errors were inadvertent and immaterial—none of the errors were so overwhelming as to rise to the level of a misrepresentation or misstatement of a material fact. Further, the Tax Court found that Eaton timely notified the IRS of these errors. The Tax Court did not see any additional material facts, mistakes of material facts, or misrepresentations that would have resulted in a significantly different APA or no APA at all. The ultimate record showed the IRS cancellation of the APAs was arbitrary, unreasonable and against its own guidance.

Implications of the *Eaton* Case

Eaton's TPM was a CUT for breaker products as described in its APAs; however, Eaton calculated a mark-up over cost that approximated the third party price. The IRS argued that Eaton was abandoning its method because it was calculating a multiplier. Similar to Eaton, many companies use a mark-up on cost because it is easier to compute and enter into financial reporting systems. Also like Eaton, many companies test their transfer pricing results at the end of their fiscal year and perform true-ups if the calculations deviate from the policy. When Eaton found data and calculation mistakes in its systems that resulted in an incorrect price, Eaton filed amended returns and reports with the IRS to correct the errors. The Tax Court found these errors were not sufficiently material to give the IRS a reason to cancel the APAs. Transfer pricing is inherently complex for taxpayers, largely due to the volume of transactions and the timing and multiple sources of data required for calculations. Undoubtedly there will be adjustments at year end, adjustments at audit, and adjustments at trial. The IRS changing its opinion on what is an acceptable TPM (*i.e.*, having "buyer's remorse" with respect to the outcome) is not a reason to retroactively cancel an APA.

Lastly, the Tax Court rejected the IRS's alternative argument under Code Section 367(d) that the Island Subsidiaries could not possibly be as profitable as they were unless intangibles were transferred to them. Having observed that there was no evidence to support the IRS argument, the court quickly dismissed it.

Conclusion and Predictions

The IRS's litigating position in *Eaton* remains consistent with the IRS's approach generally in transfer pricing cases, and in Puerto Rico manufacturing cases more specifically, to apply section 482 in a manner that allocates a large share of profits back to the United States.

The *Eaton* case highlights a common problem that taxpayers face. The IRS often asks for product-like income statements, but companies often do not keep such ledgers in the ordinary course of business. However, the IRS has begun a practice of arbitrarily applying transfer pricing to subsets of businesses to support transfer pricing adjustments.

APA cancellations are and will remain rare. The *Eaton* case demonstrates a key principle that follows a long line of section 482 cases—facts matter and will continue to control in transfer pricing cases. The *Eaton* case demonstrates that if the IRS is going to cancel an APA it should not be results-driven. Instead, the IRS must show that a material fact, had it been known, would have resulted in a significantly different APA or no APA at all. The IRS achieved a significant procedural victory, confirming the standard of review for cancelling an APA, but then lost on the merits considering the case-specific facts. The IRS has proposed similar adjustments in later tax years, which the company has contested. Consequently, this may not be the last installment in this saga.

By Amanda T. Kottke and Bob Gambino, Palo Alto

Tax Court Finds Intercompany Transactions Resulted in Investments in US Property under Code Section 956

On July 27, 2017, the US Tax Court in *Crestek, Inc. & Subsidiaries v. Commissioner*, 149 T.C. No. 5, granted the government's motion for partial summary judgment and determined that the taxpayer's controlled foreign corporations ("CFCs") held investments in US property under section 956 as a result of certain intercompany transactions. These transactions included intercompany loans from the taxpayer's CFCs to one of Taxpayer's domestic subsidiaries, a guarantee by one of the taxpayer's CFCs of a loan owed to a foreign bank, and certain trade receivables owed by one of the taxpayer's domestic subsidiaries to one of its CFCs. As a result, the taxpayer was required to include various amounts in its gross income under section 951(a)(1)(B).

Investments in US Property under Section 956

Section 951(a)(1)(B) generally requires every person who is a US shareholder of a CFC to include in gross income for its taxable year the amount of the CFC's earnings that are invested in US property under section 956. This amount cannot exceed the US shareholder's pro rata share of the average of the amounts of US property held by the CFC as of the close of each quarter of such taxable year. The amount taken into account with respect to any property is its adjusted basis as determined for purposes of computing earnings and profits ("E&P"), reduced by any liability to which the property is subject.

With certain exceptions, section 956(c)(1)(C) defines "United States property" to include obligations of a US person. Under section 956(c)(2)(C), US property does not include an obligation of a US person that arises in connection with the sale or processing of property, provided that the amount of the obligation does not exceed the amount that would be "ordinary and necessary" to carrying on both parties' trades or businesses had the transaction occurred between unrelated parties. Treas. Reg. § 1.956-2(b)(1)(v) provides that the determination of whether the amount of an obligation is "ordinary and necessary" is made based on all of the facts and circumstances.

Additionally, under section 956(d) and Treas. Reg. § 1.956-2(c)(1), a CFC is considered to hold an obligation of a US person where such CFC acts as a guarantor or pledgor of such obligation.

Background

The taxpayer, Crestek, Inc., is a Delaware corporation and the parent of an affiliated group of companies that files a consolidated US federal income tax return. One of the taxpayer's domestic subsidiaries, Crest Group Inc. ("CGI") is the sole shareholder of another domestic subsidiary, Crest Ultrasonics Corp. ("Ultrasonics"), and four foreign subsidiaries, Crest Ultrasonics Malaysia ("CUM"), Advanced Ceramics Technology Malaysia ("ACTM"), KLN Mecasonic BV ("Mecasonic"), and Crest Europe ("Crest Europe"). Crest Europe was the sole shareholder of another foreign corporation, Crest Europe GmbH ("Crest Germany"). Each of these foreign corporations was a CFC within the meaning of section 957(a). The taxpayer timely filed its consolidated Forms 1120, *US Corporation Income Tax Return*, for its fiscal years ending 2008 and 2009 ("FYE 2008" and "FYE 2009", respectively). The IRS selected these returns for examination and determined that certain intercompany transactions between the taxpayer's CFCs and its domestic subsidiaries resulted in investments in US property under section 956 that the taxpayer neglected to include in its gross income. These transactions included the following: (i) intercompany loans owing from CGI to CUM, Mecasonic, Crest Europe, and Crest Germany; (ii) CUM's guarantee of CGI's loan owing to a Malaysian bank; and (iii) certain trade receivables owed by Ultrasonics to CUM related to the sale of completed products by CUM to Ultrasonics. A brief summary of each of these intercompany transactions is provided below.

Intercompany Loans

Prior to FYE 2008, CUM, Metasonic, Crest Europe, and Crest Germany made loans to CGI. The balances on each of these loans remained outstanding (with only minor fluctuation) at each quarter end throughout FYE 2008 and FYE 2009. No portion of these loans was included by the taxpayer or CGI in its gross income for any year prior to FYE 2008.

Guaranty Transaction

With respect to the guaranty, in February of 2001, CGI borrowed funds from the Bank of Islam, a Malaysian bank. As a condition of extending the loan, the Bank of Islam required a guaranty be provided for the loan. CUM provided the guaranty. In addition, as security for the loan, CGI was required to pledge “all stocks [and] shares” that CGI owned or acquired thereafter, “all the rights, titles, and interests” and “the benefits of all rights, securities, and guarantees of any nature whatsoever” that CGI held or acquired thereafter. The balance owed on the loan as of the end of the first quarter of FYE 2008 was approximately $10.7 million and remained constant throughout FYE 2009. CUM’s guaranty was in effect from February 2001 through the end of FYE 2009. No portion of this loan was included by the taxpayer or CGI in its gross income for any year prior to FYE 2008.

Trade Receivables

Prior to 2005, CUM purchased raw materials from Ultrasonics for use in its manufacturing operations. Subsequently, CUM sold finished products to Ultrasonics and others. CUM recorded intercompany payables with respect to the purchase of raw materials from Ultrasonics and intercompany receivables with respect to the sale of finished products to Ultrasonics. CUM discontinued its manufacturing operations prior to June 30, 2005, and had no trade payables to Ultrasonics or any other US affiliate during FYE 2008 and FYE 2009. However, CUM had substantial trade receivables balances owed by Ultrasonics related to transactions that occurred before 2006. The net trade receivable balance owed by Ultrasonics to CUM was approximately $7.9 million at the end of the first quarter of FYE 2008 and remained constant throughout FYE 2009. Ultrasonics previously included approximately $2.1 million of these trade receivables in its gross income under section 951.

CUM transferred its manufacturing operations to ACTM, and ACTM continued to purchase raw materials from Ultrasonics and sell finished products to Ultrasonics and others. Like CUM, ACTM recorded intercompany trade payables and receivables in connection with these transactions. ACTM held net trade receivables owed by Ultrasonics during FYE 2008 and FYE 2009. No portion of these trade receivables were included by the taxpayer or Ultrasonics as gross income.

IRS's Position

Upon reviewing the taxpayer's returns, the IRS concluded that each of the above intercompany transactions resulted in investments in US property under section 956(c)(1)(C) by the taxpayer's CFCs. As a result, the IRS determined that the taxpayer was required to include certain amounts in its gross income under section 951(a)(1)(B) for FYE 2008 and FYE 2009. The IRS asserted deficiencies and accuracy-related penalties under section 6662(a) and (d).

Notably, the IRS believed that the conclusions in this case were so clear that it moved for summary judgment. Under Tax Court Rule 121, a motion for summary judgment will only be granted where there are no genuine disputes as to any material fact such that a decision may be rendered as a matter of law. The moving party (the IRS) bears the burden of proving that no such genuine disputes exist and the court views all factual materials and inferences in the light most favorable to the nonmoving party (Crestek, Inc.). In addition, Rule 121(d) provides that the nonmoving party may not simply rely "upon the mere allegations or denials" of the moving party's pleading but rather "must set forth specific facts showing that there is a genuine issue for trial." Thus, this summary judgment is notable in this case because it required the IRS to satisfy a very high standard in order to prevail and have the Tax Court grant its motion.

Tax Court's Opinion

The Tax Court granted the IRS's motion for summary judgment and held that the intercompany loans and the guaranty transaction each constituted investments in US property under section 956(c)(1)(C) by the relevant CFCs. With respect to the trade receivables, the Tax Court granted the IRS's motion for summary judgment in part and denied it in part because the receivables held by ACTM presented issues of material fact.

In reaching its conclusions, the Tax Court rejected three threshold arguments presented by the taxpayer. First, the taxpayer argued that the IRS's adjustments were barred by the statute of limitations. The Tax Court rejected this argument, however, and held that the taxpayer was subject to the extended six-year statute of limitations under section 6501(e)(1)(C) as a result of having omitted certain amounts includable in gross income under section 951(a).

Second, the taxpayer argued that the IRS was obligated to propose any required adjustments with respect to investments in US property under section 956 in the year in which the CFC first acquired the US property. As such, the taxpayer argued that no adjustments should be required in this case because the proposed section 956 inclusions were attributable to investments in US property that originated prior to FYE 2008. The Tax Court rejected this argument based on lack of merit, stating that, "[t]he statute does not require that the inclusion be made for the first year in which the CFC acquires its investment or that the inclusion be made for any particular year."

Third, the taxpayer argued that section 6214 requires a redetermination of its income in previous years to properly account for its current E&P in the years under examination. The Tax Court also rejected this argument, noting that the only attributes relevant for this purpose are those of the taxpayer's CFCs and not the taxpayer.

The Tax Court went on to address each of the relevant intercompany transactions. With respect to the intercompany loans, the Tax Court rejected the taxpayer's arguments that certain of the loans were "discharged" or that any section 956 inclusions should have occurred prior to FYE 2008. The Tax Court noted that the taxpayer was unable to produce any specific facts supporting its assertion that the loans had been discharged or how any such loan was discharged.

With respect to the guaranty transaction, the taxpayer argued that: (i) CUM's guaranty had little or no value because CUM was insolvent; and (ii) because CGI pledged adequate collateral, the Bank of Islam viewed the guaranty as nothing more than a "meaningless gesture." The taxpayer did not provide any specific facts or documentation to support either argument. The Tax Court ultimately rejected both arguments as irrelevant, noting that: (i) section 956 does not require that the guarantor be solvent; and (ii) it is logical to assume that the Bank of Islam did not consider the guaranty a "meaningless gesture" if it was a requirement for extending the loan. Notably, it is interesting that the Tax Court even entertained the taxpayer's arguments regarding CUM's insolvency given that, as the Tax Court concluded, CUM's financial condition was ultimately irrelevant due to the mechanical operation of the section 956(d) rules with respect to pledgor and guarantor arrangements.

Lastly, with respect to the trade receivables, the taxpayer argued that the exception for "ordinary and necessary" amounts under section 956(c)(2)(C) applied. The Tax Court disagreed with respect to the trade receivables owed by Ultrasonics to CUM because CUM discontinued its manufacturing operations in 2005 and, thus, had not been engaged in an active trade or business for several years. Thus, the Tax Court held they could not be "ordinary and necessary." With respect to the trade receivables owed by Ultrasonics to ACTM, however, the Tax Court held that whether the "ordinary and necessary" exception applied was a question of material fact for which a trial was required.

Key Points

Taxpayers should take care to maintain complete and current documentation with respect to their intercompany transactions, in particular those that may give rise to investments in US property under section 956. Moreover, to the extent taxpayers have CFCs with investments in US property, such transactions should be carefully monitored to ensure proper reporting. Taxpayers should also be aware that, as illustrated in this case, if a CFC holds an investment in US property for multiple years, such investment may give rise to an inclusion in gross income for any of those years and not only the year in which the investment originated.

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Big Changes for Illinois Unclaimed Property Law – Holders Beware!

Illinois' state budget bill, SB 9, passed on July 7, 2017, includes drastic changes to Illinois' unclaimed property law. Under SB 9, Illinois' new unclaimed property law will become effective on January 1, 2018 and the state's current unclaimed property law will be repealed. Holders of unclaimed property in Illinois should take note of this development, as many aspects of Illinois' new unclaimed property law represent a significant departure from current law and could have a negative and costly impact. The following are some of the important changes set to take effect under Illinois' new unclaimed property law: (1) Illinois' long-standing business-to-business exemption will be eliminated, meaning that property due or owed between business entities in the normal and ordinary course of business will become subject to an Illinois unclaimed property reporting obligation; (2) contractual limitations periods will be disregarded, meaning that the running of a contractual limitations period in a private party contract will not operate to prohibit the state from claiming that property is subject to escheat; and (3) certain "stored-value cards" will be subject to escheat if they do not meet the definition of a "gift card". Further, the potential negative impact is exacerbated by the fact that Illinois' new unclaimed property law purports to be applicable retroactively and requires retroactive reporting for all property types that would have been presumed abandoned under the new law during the five years prior to January 1, 2018. As such, companies with potential unclaimed property liability exposure in Illinois should consult their advisors regarding issues that could arise under Illinois' new unclaimed property law.

For more discussion and insight on Illinois' new unclaimed property law, please see the SALT Savvy blog post from August 28, 2017, *Big Changes for Illinois Unclaimed Property Law – Holders Beware!*, available at http://www.saltsavvy.com/.

Warning! California Real Estate Transfer Tax Trap at 926 N. Ardmore Avenue

On June 29, 2017, in *926 North Ardmore Avenue, LLC v. County of Los Angeles*, 219 Cal. Rptr. 3d 695 (Cal. June 29, 2017), the Supreme Court of California upheld the imposition of Los Angeles County's Documentary Transfer Tax ("L.A. Transfer Tax") on the transfer of a controlling interest in a partnership that indirectly owned Los Angeles real estate through an LLC. The court found "that the tax may be imposed if the document reflects a sale: that is, an actual transfer of legal beneficial ownership made for consideration."

At issue in the case was the transfer of approximately 90% of the beneficial interest in a partnership that indirectly held title to Los Angeles County real property ("L.A. Real Estate"). Although the L.A. Transfer Tax is not expressly imposed on transfers of a controlling interest in an entity that owns real property, the Los Angeles County registrar-recorder assessed L.A. Transfer Tax on

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grounds that the L.A. Real Estate had undergone a “change in ownership” under the ad valorem property tax rules.

In evaluating the L.A. Transfer Tax assessment and its reliance on ad valorem property tax determinations for changes in ownership, the Supreme Court of California concluded that the “critical factor in determining whether the documentary transfer tax may be imposed is whether there was a sale that resulted in a transfer of beneficial ownership of real property” and found that the ad valorem property tax rules for changes in ownership were “designed to identify precisely the types of indirect real property transfers that the Transfer Tax Act is designed to tax.” Accordingly, the court upheld the imposition of the L.A. Transfer Tax, despite the fact that the direct ownership of the property did not change. This result has implications throughout California, as other local tax jurisdictions may similarly seek to impose their real estate transfer tax when changes in ownership of legal entities that own California real estate occur for ad valorem property tax purposes.

For a full discussion of *926 North Ardmore Avenue, LLC* and its potential implications for owners of California real estate, please see *Warning! California Real Estate Transfer Tax Trap at 926 N. Ardmore Avenue* on the SALT Savvy blog**,** available at www.saltsavvy.com.

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