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In This Issue:

"It's not EU, it's me:" Britain Breaks Up with the European Union

Actual Transactions v. Hypothetical Profits: *Medtronic, Inc. v. Commissioner*

Third Circuit Interprets "All Events" Test Favorably for Giant Eagle

Pre-Filing Agreements Cost More, Cover More: IRS Guidance

A Thousand Points of Light, Yet No Illumination on the Path to Tax Reform

Senate Finance Committee Advances Legislation Overturning Temporary IRS Regulations Allowing the Use of Outside Counsel

2015 Competent Authority Statistics Show Uptick in Settlements; Increased Inventory

Federal Court Holds Delaware Unclaimed Property Audits "Shock the Conscience"

CheckFree Services' Secret Sauce Not Subject to Texas Sales Tax

South Dakota and Alabama Hatch *Newegg* Challenges to *Quill*

Five Things You Need to Know About the New York State Draft Combined Reporting Regulations

Canadian Tax Update

Treasury Issues Temporary Regulations on Inversions

Attorney-Client Privilege And A Law Firm Leak

European Anti-Tax Avoidance Directive: Agreement Reached

IRS Issues Proposed Regulations Altering Compliance Requirements of Wholly Foreign Owned US Domestic Disregarded Entities

Getting Better All The Time…Baker & McKenzie Adds New Talent to its Partnership and Real Estate Tax Planning Practice

Baker & McKenzie and Bloomberg BNA Turn to Toronto and Hong Kong for Their Upcoming Transfer Pricing and International Tax Conferences

"It's not EU, it's me:" Britain Breaks Up with the European Union

On June 23, 2016, voters in the United Kingdom came out marginally in favor of ending the country's membership in the European Union. The 'Leave' (or 'Brexit') campaign obtained a 51.9% share of the vote, compared to the 'Remain' campaign's 48.1%.

The result has had immediate economic and political consequences. The value of Sterling has slumped considerably (early on June 24, it fell more than 10% against the dollar to below the $1.33 mark, its weakest since the mid-1980s); several stock markets around the world opened to sharp falls; and UK Prime Minister David Cameron announced that he would remain in office for the next few months to "steady the ship," but that he would then resign to afford Britain "fresh leadership."

Amid the current and forthcoming economic and political upheaval, the result also poses serious questions about the United Kingdom's prospects as a 'united' kingdom and the extent to which the European Union can maintain a 'union.' Scotland voted in favor of the United Kingdom staying in the European Union by 62% to 38%. Against that backdrop, Scotland's First Minister has said that a second Scottish independence referendum is "highly likely" and that it was "democratically unacceptable" that Scotland faces the prospect of being taken out of the European Union against its will. Meanwhile, many commentators and European politicians believe that the outcome of the United Kingdom's referendum could have a domino effect in other European Union jurisdictions. Notably, leaders of Eurosceptic parties in France, the Netherlands, Sweden and Italy have already demanded membership referendums in their own countries.

Constitutional Implications of Brexit

Immediate Consequences

Although the referendum result is not legally binding, it is a political certainty that the UK Government will now proceed to present an application to withdraw from the European Union.

The formal route for the United Kingdom's departure from the European Union is via Article 50 of the Lisbon Treaty. Article 50 sets out a basic template for how a member state leaves the European Union. Article 50 establishes how a negotiator is selected, a two year (renewable) deadline for negotiations, and the voting arrangements by which an agreement can be reached (weighted majority) or the two year deadline can be extended (unanimity).

Upcoming Tax Events

- Interactive Roundtable on the Latest Developments in Transfer Pricing

  Minneapolis, MN
  July 28, 2016

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

  Toronto, Ontario
  August 29-30, 2016
  *Register with corporate guest code **BAKTR16***

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

- Baker & McKenzie/Bloomberg BNA International Tax Conference

  Toronto, Ontario
  August 31, 2016
  *Register with corporate guest code **BAKITC16***

- Baker & McKenzie/TEI International Tax Day

  Santa Clara, CA
  October 25, 2016

  Orange County, CA
  October 26, 2016

  Seattle, CA
  October 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

Article 50 is clear that only the departing member state can decide when to 'pull the trigger' - only the UK Government can decide if and precisely when to invoke Article 50; it is not a mechanism through which the European Union can 'evict' a member state. UK Prime Minister David Cameron has stated that, in his view, it should be for his successor (likely to be selected in early October this year) to determine when to activate Article 50. However, on the morning of June 24 the heads of the European Commission, the European Council and the European Parliament released a statement calling for the United Kingdom "to give effect to this decision … as soon as possible, however painful that process may be. Any delay would unnecessarily prolong uncertainty." There is undoubtedly going to be significant pressure put on the United Kingdom to invoke the Article 50 process sooner rather than later.

However long the exit process takes, one thing that is clear is that, the United Kingdom will remain a member of the European Union throughout that period and, as such, EU law will continue to stand in the United Kingdom.

Future United Kingdom/European Union Relations

Given the importance of the relationship between the European Union and the United Kingdom, any UK Government will effectively be obliged to maintain some formal relationship with the European Union. What that relationship will be, and how the United Kingdom and European Union will arrive at it is currently unknown. Many commentators and practitioners have expressed the view that the United Kingdom's future relationship with the European Union will:

a) closely resemble a type of relationship that is already in place between the European Union and another non European Union country (namely, one of Norway, Turkey and Switzerland, each of which have their own unique interaction with the European Union);

b) rest on the basis of a free trade agreement concluded between the United Kingdom and the European Union (alongside a series of bilateral free trade agreements concluded between the United Kingdom and non European Union countries); or

c) rest on the basis of the World Trade Organization's rules applying to the United Kingdom's right to trade with the European Union in respect of both goods and services.

In relation to (a) above, it should be borne in mind that Norway's relationship with the European Union includes both the free movement of persons and contributions to the EU budget and Switzerland's relationship with the European Union also includes contributions to the EU budget. Both of these elements were particularly high profile and divisive issues throughout the United Kingdom's referendum campaign (indeed, many senior figures within the 'Leave' campaign committed to ending EU budget contributions from the United Kingdom and free movement of persons into the United Kingdom). Arguably, this raises material doubts over to the extent to which the Norwegian and Swiss models could actually be replicated by the United Kingdom.

Crucially, most experts in London and Brussels agree that Article 50 is only relevant for determining the terms of a member state's exit. Any future trade deal (or similar matters) between the United Kingdom and the European Union would be concluded as a result of a process separate to discussions held pursuant to Article 50. As such, notwithstanding the fact that the UK Government will almost certainly be eager to conclude agreements with the European Union regarding trade (and similar matters), it is conceivable, given the complexity and typical duration of such negotiations, that no such agreements may be in place between the United Kingdom and the European Union at the time of the United Kingdom's eventual exit from the European Union.

Tax Implications of Brexit

Broadly speaking, the EU tax rules that have been incorporated into UK law are intended to create a level playing field for companies and to remove tax obstacles to cross-border activity. European Union member states are required to exercise their power to tax consistently with EU law (and the fundamental freedoms enshrined in EU law). For example, on that basis, the United Kingdom has previously been required to amend its domestic tax laws (regarding, notably, controlled foreign companies and loss relief) to ensure consistency with EU law. In the short term, the vote for Brexit is unlikely to have any material impact on the UK tax environment, because these EU rules and freedoms will continue to have effect.

The United Kingdom's tax system will also continue to be subject to other international influences. In particular, the Organisation for Economic Co-operation and Development is becoming increasingly influential in various aspects of tax policy. Indeed it is expected that there will be further efforts to align the tax regimes of most economies (including those of the United Kingdom and European Union) with the recommendations made by the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project.

Direct Tax

In the longer term, the United Kingdom's eventual exit will mean that it will not be bound by, nor benefit from, the European Union's initiatives in relation to direct taxation.

There are various ongoing EU initiatives in the field of direct taxation, including: the European Commission's investigation into tax rulings and State Aid issues, the European Commission's transparency package (which requires, amongst other things, exchange of rulings between tax authorities), the European Commission's Action Plan on Corporate Taxation (which includes a proposal for a mandatory Common Consolidated Corporate Tax Base), and the recently agreed Anti-Tax Avoidance Directive (which includes provisions that relate to controlled foreign company regimes, interest deductibility rules, exit taxation, and hybrid mismatches, alongside a general anti-abuse rule).

In addition, the United Kingdom may no longer benefit from the European Union's Interest and Royalties Directive (which removes the obligation to withhold tax on payments of interest and royalties to related companies in other member states) or the Parent-Subsidiary Directive (which has the same effect for dividends). Although, under the United Kingdom's extensive network of double tax treaties, the interest withholding obligation is reduced or even eliminated, and

the United Kingdom does not apply withholding tax to dividends as a matter of domestic law, losing the benefit of these EU Directives may reduce the United Kingdom's attractiveness as a holding company location in certain circumstances. Conversely, it is also possible that Brexit enables the United Kingdom to adopt business friendly measures (not only in relation to taxation, but also, for example, in terms of corporate law and financial regulation) to a degree that it could not achieve whilst a member state of the European Union (in light of the need to comply with EU law).

Indirect Tax and Customs Duties

Value Added Tax (VAT) is a significant source of revenue for the UK Government and, as such, the United Kingdom will almost certainly retain a VAT system (possibly in the form of a sales or goods and services tax). Nevertheless, post-Brexit, the United Kingdom will have the freedom to develop its own rules (for example, on which services are 'zero-rated' or 'exempt,' in order to support certain sectors).

One area which could see significant change in the longer term, however, is customs duty on the cross-border transfer of goods.

Subject to what trade deal (if any) the United Kingdom is able to negotiate with the European Union and with other countries with which the European Union currently has trade deals, this could result in:

a) customs duty (and import VAT) being payable for imports into the United Kingdom from the European Union and *vice versa* (coupled with the administrative burden of filing import and export declarations etc.); and

b) customs duty being payable for imports into the United Kingdom from countries with which the European Union has trade deals and *vice versa* (import VAT is already payable and import/export declarations already need to be filed for such movements).

Other Resources

Baker & McKenzie's London office has a dedicated website, www.bakermckenzie.com/brexit, where you can find the most recent materials in relation to Brexit.

In addition, the London office has produced a checklist that outlines the core questions that an organization should be asking itself in order to understand the implications of Brexit.

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

Actual Transactions v. Hypothetical Profits: *Medtronic, Inc. v. Commissioner*

In June 2016, the Tax Court rejected the IRS position in the transfer pricing case with Medtronic, Inc. & Consolidated Subsidiaries (collectively, "Medtronic"). *Medtronic, Inc. v. Commissioner*, T.C. Memo. 2016-112 (June 9, 2016). The Tax Court determined that: (1) the IRS's determined deficiencies under Code Section 482 were arbitrary, capricious or unreasonable; (2) the comparable uncontrolled transaction ("CUT") method was the best method and the transaction proposed by Medtronic could be adjusted; and (3) no intangibles were transferred to Medtronic Puerto Rico Operations Co. ("Medtronic Puerto Rico") that should be subject to Code Section 367(d).

Summary of Findings of Fact

Medtronic has maintained operations in Puerto Rico since 1974. Following the repeal of Code Section 936, Medtronic restructured its Puerto Rican operations into controlled foreign corporation status in 2002. Medtronic Puerto Rico is responsible for, among other things, manufacturing and selling Cardiac Rhythm Disease Management ("CRDM") and Neurological ("Neuro") medical device pulse generators ("Devices") and medical therapy delivery devices ("Leads"). Medtronic Puerto Rico purchases certain component parts used in Devices and Leads from Medtronic, Inc. (individually, "Medtronic US") and licenses the intangible property necessary to manufacture and sell Devices and Leads from Medtronic US, as well as the requisite trademarks and trade names. Medtronic Puerto Rico sells finished Devices and Leads to Medtronic USA, Inc. ("Med USA") primarily for sale into the United States.

Medtronic Puerto Rico's operations were facilities registered with the US Food and Drug Administration (the "FDA"), subject to regular pre-market and post-market inspection by the FDA, as well as by other international regulatory agencies, and solely responsible for manufacturing the products that are ultimately implanted in patients. Medtronic Puerto Rico was responsible for, *inter alia*, its quality compliance, operational excellence, business profitability, innovation, supplier relationship management and the establishment of strategic goals and objectives. Medtronic Puerto Rico's engineers, further, played an integral role in assisting with product development, project implementation, technology harvesting and process development. They also interacted with product design engineers at Medtronic US to ensure that products could be designed and manufactured at commercial scale repeatedly, reliably and at the highest levels of quality.

Medtronic US and Medtronic Puerto Rico entered into license agreements for the intangible property necessary to manufacture and sell Devices and Leads (collectively, the "Device and Leads Licenses"). Under the licenses, Medtronic Puerto Rico obtained the exclusive right to use, develop and enjoy the intangible property used in manufacturing Devices for sale to customers in the United States and Leads for sale to customers worldwide. Medtronic Puerto Rico agreed to pay an arm's length royalty of 29% to Medtronic US on its US net intercompany sales of Devices (20% on trade sales) and 15% to Medtronic US on its worldwide net intercompany sales of Leads (11% on trade sales).

Following the audit of Medtronic's 2002 tax year, in 2006, Medtronic and the IRS entered into a memorandum of understanding (the "Puerto Rico MOU"), dated October 13, 2005, with respect to the intercompany transactions among Medtronic US, Med USA, and Medtronic Puerto Rico for 2002 and all subsequent years. Pursuant to the Puerto Rico MOU, Medtronic Puerto Rico was to pay a royalty rate of 44% for Devices and 26% for Leads on its intercompany sales.

The Parties' Positions

The IRS's position was that the comparable profits method ("CPM") was the best method to determine the arm's length royalty rates on the intercompany sales of Devices and Leads. The IRS contended that the only economically significant function that Medtronic Puerto Rico performed was "assembling" finished products with Medtronic US's significant oversight and help. The IRS argued that the four intercompany transactions should have been aggregated. The IRS, further, contended that Medtronic's use of the CUT method did not meet the standard of section 482 and the regulations thereunder, and that Medtronic's experts' uncontrolled license agreements were not comparable to the Device and Leads Licenses.

Medtronic argued that the Puerto Rico MOU royalty rates on the intercompany sales of Devices and Leads from Medtronic Puerto Rico to Medtronic US were greater than arm's length. Medtronic contended that, using the CUT method, the proper arm's length intercompany royalty rates were 29% for Devices and 15% for Leads. Medtronic maintained that the separate intercompany transactions should be respected and priced individually.

The Court's Decisions

The Arbitrary, Capricious or Unreasonable Standard

The Court examined the economic analysis of the IRS's valuation expert, Dr. A. Michael Heimert, and found his overall value chain valuation approach using the CPM to be lacking. The Court found that "Heimert's analysis was based on his findings that [Medtronic Puerto Rico] performed one important function -- finished manufacturing -- among many important functions within the highly integrated value chain. This approach treated [Medtronic Puerto Rico] as equivalent to many other third-party medical device manufacturers." The Court observed that the IRS and Heimert's minimization of the role of quality was incorrect, and agreed with Medtronic regarding the significance of quality in the industry and Medtronic Puerto Rico's role in ensuring that high quality. In the Court's view, "[t]he final product is the key to success. Product quality is the foundation for which implantable medical devices can be successful."

The Court, further, found that Heimert's asserted comparables to Medtronic Puerto Rico were inconsistent with the regulations. The Court also disagreed with Heimert's use of the return on assets ("ROA") to determine whether a transaction was arm's length. The Court criticized the asserted comparable companies as not performing the same functions as and not manufacturing the same types of products as Medtronic Puerto Rico. The Court found that Heimert's aggregation approach was not the best method and that, therefore, Medtronic had met its burden of showing that the IRS's allocations were arbitrary, capricious or unreasonable. The Court concluded that the prices charged for the components and finished goods were arm's length and that the trademark royalty was also arm's length.

The Device and Leads Licenses' Allocations

The Court next turned to determining whether the royalty rates contained in the Device and Leads Licenses met the arm's length standard. Medtronic contended that one transaction was most comparable to the Device and Leads Licenses and demonstrated that Medtronic's allocations were arm's length. Specifically, in August 1992, Medtronic US and Siemens Pacesetter, Inc. ("Pacesetter") finalized the terms of a settlement agreement to resolve numerous patent litigation lawsuits related to Medtronic US' patents for many of its cardiac rhythm stimulation devices, including patents underlying its pacemakers' rate-responsive technology that monitors and adapts to changes in cardiac rhythm. As part of a contemporaneous license agreement (the "Pacesetter Agreement"), and to "buy peace," the parties agreed to cross-license their pacemaker and patent portfolios. Following certain royalty prepayments, Pacesetter agreed to pay Medtronic US a 7% royalty on the sale in the United States and a 3.5% royalty on all sales outside the United States.

Medtronic's licensing expert, Louis P. Berneman, testified that the Pacesetter Agreement was the best comparable transaction because "it deals with the same patents, the same market, the same product, in the same time frame, for the same customers, and offers the same profit potential." Berneman made certain adjustments to the Pacesetter Agreement, however, to address the exclusivity and know-how provisions contained in the Device and Leads Licenses. Berneman opined that the royalty rate for the Pacesetter Agreement as a comparable was approximately 16% to 17% of trade sales, and that the appropriate royalty range for technology licenses is between 0.5% and 20% of sales. Thus, Berneman concluded that the 29% intercompany royalty rate in the Device License and the 15% intercompany royalty rate in the Leads Licenses were consistent with arm's length behavior.

While the Court found that Medtronic had failed to meet its burden of proving that its allocations met the arm's length standard, so too did the Court deem the IRS's "all-or-nothing approach" to determining comparability unreasonable. Following a long line of precedent, the Court determined that the CUT method was the most appropriate means of determining the arm's length royalty rates of the Device and Leads Licenses, despite the fact that it deemed the Pacesetter Agreement "imperfect." See *Veritas Software Corp. & Subs. v. Commissioner*, 133 T.C. 297, 335 (2009); *Sundstrand Corp. & Subs. v. Commissioner*, 96 T.C. 226. 393 (1991); *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 589 (1989), aff'd, 933 F.2d 1082 (2d Cir. 1991).

The Court stated that the Pacesetter Agreement was sufficiently similar to the controlled transactions at issue to provide a reliable measure of an arm's length result and that Berneman's adjustment to the royalty rate contained in the Pacesetter Agreement of 17% was a valid starting point and made adjustments to the royalty rate resulting in a 30% of trade sales royalty for Devices. Thus, the Court found that an appropriate arm's length intercompany royalty rate for Devices would be 44%. The Court determined that a royalty rate of 22% was appropriate for the Leads License.

The Transfer of Intangible Property Under Section 367(d)

The Court determined that the IRS had not identified or alleged that any specific intangibles were transferred to Medtronic Puerto Rico by the section 936 possession corporations. The Court stated that "the gist of respondent's argument seems to be that [Medtronic Puerto Rico] could not possibly be as profitable as it is unless intangibles were transferred to it. We are not persuaded by this argument." Thus, the Court held that no intangibles were transferred to Medtronic Puerto Rico that should be subject to section 367(d).

Conclusion

The Court provided Medtronic with a significant victory. The Court rejected the IRS's aggregation approach, which focused on profits, and the Court analyzed a CUT transaction for the licensed manufacture of finished goods.

Thomas V. Linguanti, Robert J. Cunningham, Robert S. Walton, Jenny A. Austin, Jason Dimopoulos, Kent P. Stackhouse and Katie M.B. Marcusse led the Baker & McKenzie team that represented the taxpayer in this case.

By Jason Dimopoulos, Chicago

Third Circuit Interprets "All Events" Test Favorably for Giant Eagle

On May 6, 2016, the Third Circuit issued its opinion in *Giant Eagle Inc. v. Commissioner*, No. 14-3961 (3d Cir. 2016) addressing whether Giant Eagle was permitted deductions based on rewards shoppers had earned but not yet redeemed under the "all events" test. The Third Circuit held that Giant Eagle's rewards program established a unilateral contract with customers creating fixed liability when customers checked out and purchased goods, thus satisfying the "all events" test for deductions even if the customers did not redeem these rewards within the taxable year. This decision results in the reinstatement of the deductions for 2006 and 2007, the tax years at issue.

The court's 2-1 decision reversed the Tax Court's holding that the claimed deductions failed the "all events test" because there was an additional condition precedent (purchase of gasoline) to the redemption of the rewards (ten-cents-per-gallon discount on gas). The Tax Court also held that the rewards could not be considered "trading stamps or premium coupons" under Treas. Reg. § 1.451-4(a)(1) because the rewards were not redeemable for "merchandise, cash, or other property" and therefore Giant Eagle could not subtract the estimated cost of redemption of the rewards from gross receipts when calculating taxable income.

Giant Eagle's "fuelperks!" rewards program entitled an Advantage Cardholder to a ten-cents-per-gallon discount on gas for every $50 spent on qualifying groceries. Giant Eagle's literature stated that the gasoline discounts expire on the last day of the month, three months after they are earned. Giant Eagle did not ever revoke any accumulated discounts during the tax years at issue.

To determine the deduction, Giant Eagle calculated the amount of rewards shoppers earned, then discounted the earned rewards by the historic redemption rate to determine the estimated amount of claimed deduction.

The "All Events" Test Requirements

Due to the recurring nature of the rewards program liabilities, Code Section 461's relaxed all events test for recurring liabilities states that "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."

The Commissioner conceded that Giant Eagle calculated the rewards program liability "with reasonable accuracy." The court therefore focused on whether the "fact of liability" was fixed before the end of the taxable year, as the "all events" test required.

"Fixed Liability" Standard

The Third Circuit relied on Supreme Court precedent, and a persuasive holding from the Ninth Circuit to establish standards for "fixed liability." The court first examined two Supreme Court decisions that shape the "all events" test. In *United States v. Hughes Properties, Inc.*, 476 U.S. 593 (1986) the Court concluded that when a casino's liability for a jackpot was "fixed" under state law, the casino was entitled to deduct the annual increase in its progressive jackpot payoff, even in spite of the "extremely remote and speculative possibility [] that the jackpot might never be won." In a later decision, *United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), the Court held that a commercial taxpayer was not entitled to deductions claimed to reimburse employees for medical expenses incurred by year's end but not yet submitted for reimbursement on an official claim form because the submitted forms were considered "the last link in the chain of events creating [employer] liability" and thus the taxpayer's liability was not yet "fixed."

The Ninth Circuit Court of Appeals in *Gold Coast Hotel & Casino v. United States*, 158 F.3d 484 (9th Cir. 1998) explained that while the "remote and speculative possibility" existed that a liability might never be paid, "for purposes of the 'all events' test, what is critical is the existence of an *absolute liability*, not an *absolute certainty* the liability will be discharged by payment." In *Gold Coast Hotel & Casino*, gamblers' earned but unredeemed rewards could be deducted as liabilities because the redemption was considered a simple technicality not involving third parties, as distinct from *General Dynamics*'s form requirement.

The Third Circuit also noted that fixed liability could be found even without determining the exact amount of liability, to whom the liability was owed, or the exact timing of the liability. The Federal Circuit Court of Appeals held that in *Massachusetts Mutual Life Insurance Co. v. United States*, 782 F.3d 1354 (Fed. Cir. 2015) that liability for future dividends may be fixed due to a board of director's guarantee, even without certainty as to the exact amount of liability or to which precise policy holders would receive the payment. The Third Circuit's sole prior decision on the general subject (pre-dating the codification of the 'all events' test) occurred in *Luken Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971). In *Luken Steel* because the taxpayer had irrevocably committed to payments under a collective bargaining agreement the taxpayer was entitled to deduct future liabilities that "would be paid in a reasonable period of time" even though the payments "would not be paid out immediately or at a specified time."

Was Liability 'Fixed' Here?

The Third Circuit examined unilateral contract principles to determine whether *Giant Eagle's* liability was fixed. As explained in *First Home Sav. Bank, FSB v. Nernberg*, 648 A2d 9, 14(Pa. Super. Ct. 1994), unilateral contracts "are formed when one party makes a promise in exchange for the other party's act… [and are] not formed and [are] thus unenforceable until such time as the offeree completes performance." The Pennsylvania court held that only the "manifest intent" of the offeror, not the subjective intent of the offeror, established the power to accept the offer.

In the case of *Giant Eagle*, customers could have "reasonably presumed the redeemability" of accumulated rewards, and there was no suggestion that "Giant Eagle reserved the right to retract rewards that customers had already accrued." The court held that customers became party to a unilateral contract by anticipating the rewards in making shopping decisions, choosing to shop at Giant Eagle using their Advantage Cards rather than at other stores. "Liability therefore attached on [customer] performance, *i.e.*, at checkout."

Finally, because the "all events" test's fixed liability requires neither that Giant Eagle's total amount of liability be known nor that Giant Eagle identify the specific customers to whom the liability is owed, and because the Commissioner had conceded that Giant Eagle calculated the chance of non-redemption "with reasonable accuracy," Giant Eagle had met all requirements for the "all events" test and was entitled to the rewards program deductions.

Taxpayers with significant rewards liabilities should consider whether this case affects their existing practices with respect to deductions.

By Ian Yuon Siu, Palo Alto

Pre-Filing Agreements Cost More, Cover More: IRS Guidance

On May 4, 2016, the IRS issued updated procedures for LB&I's Pre-Filing Agreement ("PFA") program. The PFA program, which was first rolled out as a pilot program in February of 2000 and was made permanent in 2009, was designed to encourage taxpayers to request consideration of issues before the tax return is filed and resolve potential disputes earlier and more efficiently. The PFA program, while generally viewed as a successful one by taxpayers who have taken advantage of it, remains relatively small, with 17 applications received in 2015, 12 of which were accepted into the program. This is due, in part, to the limited scope of issues that are eligible for the PFA program—primarily factual issues and issues involving application of well-settled principles of law—and to the upfront investment that is required for taxpayers to access the program, including payment of a user fee.

The updated PFA Revenue Procedure, Rev. Proc. 2016-30, reflects a continuing commitment by the IRS to the PFA program, which is reassuring in the midst of the myriad of organizational changes that LB&I is currently undergoing. As a general matter, Rev. Proc. 2016-30 makes only minor modifications to the prior PFA Revenue Procedure, including an expansion of the method of accounting issues eligible for the PFA program. This expansion, however, is accompanied by a significant increase to the user fee that taxpayers must pay to take advantage of the program.

Tax Periods and Issues Eligible for PFA Procedures

Rev. Proc. 2016-30 clarifies, consistent with prior procedures, that PFAs are available to taxpayers under the jurisdiction of LB&I and may be requested for the current tax year, any prior tax year for which a return is not yet due (taking filing extensions into account), and, in general, for four tax years beyond the current one.

As under prior revenue procedures, Rev. Proc. 2016-30 generally limits the scope of issues that can be addressed through a PFA to fact-intensive issues. These include issues that require (1) a factual determination, (2) application of "well-established legal principles to known facts," and (3) analysis of a methodology employed by a taxpayer to "determine the appropriate amount of an item of income, allowance, deduction, or credit." Issues commonly addressed through the PFA process include issues related to research credit, worthless stock/bad debt deductions, deductibility of settlement or fine payments, cost segregation studies, withholding and reporting requirements, and application of Code Section 199, among others. The current and previous PFA procedures do not explicitly identify the types of issues available for a PFA but do identify several types of issues that are ineligible for PFA procedures. Guidance regarding these excluded issues remains the same as in prior years, with the exception of procedures related to changes in accounting methods.

Under prior guidance, PFAs were allowed with respect to issues for which the IRS had already issued a letter ruling that consented to a change in accounting method. PFAs were not permitted with respect to any change in method of accounting requested through automatic consent procedures. Rev. Proc. 2016-30 reverses this policy by permitting PFAs with respect to automatic changes in method of accounting for which the required Form 3115 has been timely filed. In particular, the updated PFA Revenue Procedure clarifies that PFAs may address issues that would be subject to review by the IRS under the automatic change procedures outlined in Rev. Proc. 2015-13 (or corresponding requirements in prior or subsequent procedures). These issues are largely factual in nature and include analysis of whether:

(1) The taxpayer based its requested change in accounting method on a complete and accurate statement of material facts;

(2) The taxpayer properly determined the amount of the Code Section 481(a) adjustment;

(3) The taxpayer properly implemented the change in accounting method;

(4) Any change in material facts has occurred that may impact the requested change in accounting method; and

(5) Any change in the applicable law has occurred that may impact the requested change in accounting method.

With the exception of section 481(a) adjustments, PFAs related to changes in accounting methods apply only to the taxable year of change. Determinations regarding the amount of available section 481(a) adjustments apply to the taxable years for which such adjustments are taken into account (*i.e.*, any spread period).

Increased Fees

As noted above, there has been a significant increase to the user fee required to take advantage of the PFA program. The current user fee is $50,000, but this fee will be increased to $134,300 for requests submitted on or after June 3, 2016, and to $218,600 for requests submitted on or after January 1, 2017. This user fee must be paid electronically within 15 business days of notification to the taxpayer that the issues identified in the taxpayer's PFA application have been accepted into the program.

Is It Worth Pursuing a PFA?

While the updated PFA procedures expand the scope of issues that may be addressed by PFAs and substantially increase the user fee for engaging in PFA procedures, it is not clear that these changes should have a material impact on decisions by taxpayers to pursue PFAs, particularly when the dollar amounts involved are high. A decision to pursue a PFA should, in each case, take into account the benefits, costs and risks of seeking and obtaining a PFA.

For many taxpayers, the PFA process is more efficient than addressing issues through traditional audit procedures. In 2015, it took an average of 344 days from the date on which a PFA application was filed to resolve the PFA issue, which is quite a bit faster than the time required for a traditional audit. This is consistent with the average PFA completion time over the past 10 years, which is 355 days. According to the IRS, taxpayers estimate that they save 48% by using this process rather than the traditional audit. These figures presumably do not take into account the increased user fees that have just gone into effect, but such user fees may be a small price to pay in the context of big dollar issues that are likely to consume significant resources in the context of an IRS audit. The PFA also provides taxpayers with certainty regarding positions taken on their tax returns for the current year and up to four future years. In addition, this process increases the likelihood that the taxpayer will be able to access records and personnel that may be relevant to resolution of issues to be addressed in the PFA. The PFA process also encourages and facilitates joint development of methodologies for addressing fact-intensive questions, which is far less likely to occur in the post-filing context.

All that said, the upfront investment in preparing a PFA application and pursuing the PFA process is not insignificant, and both the costs and risks of pursuing this process should be weighed against its anticipated benefits. For example, even after a taxpayer has invested resources in preparing a PFA application, there is no guarantee that the IRS will agree to address issues identified in that application. Indeed, according to the PFA statistics most recently released by the IRS, the IRS has accepted only 349 of the 530 applications filed since inception of the program, indicating only a 65% acceptance rate. According to data provided by the IRS for 2005 through 2015, the likelihood of acceptance appears to vary according to the issue and is higher than the overall 65% acceptance rate for some of the issues that the IRS most commonly addresses through the PFA process. Data on rates of acceptance and resolution of cases for 2005-2015 for several of the more common issues is summarized below.

Issue	Received	Accepted	Closed
IRC 41, Research Credit	59	37	32
Worthless Stock/Bad Debt Deduction	38	29	24
Gain/Loss on Sale/Exchange of Property/Stock	29	25	25
Deductibility of Settlement/Fine Payments	24	24	17
Cost Segregation Study and Depreciation Deduction	18	15	15
Withholding and Reporting Requirements	16	10	11
IRC 199	13	7	7

This summary is based on data provided by the IRS in its yearly PFA statistics for each of 2005-2015, as available on www.irs.gov.

Fortunately, as noted above, no user fee is due until after the IRS accepts an issue into the PFA program, but taxpayers still must take the time and effort to prepare the PFA application before finding out whether they will be accepted into the program. There is, further, no guarantee that the process will result in an agreed resolution of the relevant issues. It is also possible that submission of a PFA application may alert the IRS to issues that had not previously been on their radar and could increase the likelihood that such issues are investigated on audit. This risk is, of course, lower with respect to issues that have been investigated in prior audit cycles and with respect to prominent issues that are likely to be investigated on audit in any case. Each of these factors should be considered in determining whether it is worth seeking a PFA.

By Summer Austin, Washington, DC

A Thousand Points of Light, Yet No Illumination on the Path to Tax Reform

As we get closer to the November elections and various Members of Congress focus on their Congressional races, the likelihood of tax reform in 2016 continues to diminish. Although both the House Ways & Means Committee and the Senate Finance Committee continue to hold hearings and undertake the preparatory work necessary for tax reform, members of both parties appear to be hoping that their party will win the White House and control of Congress in November, smoothing the way for tax reform in 2017. Whether those hopes are realistic, or merely wishful thinking, it’s too early to tell.

The House of Representatives

In April, the Republican Study Committee (RSC) announced that it established several task forces to develop a Republican policy agenda. The task forces are to create the platform for the Republican Party and its nominee, Donald Trump. One of the task forces was instructed to address “fixing the tax code” to make it flatter, fairer and simpler. The RSC included some proposals for tax reform in its April study paper, including (1) taxing corporations and pass-through businesses at the same rates, (2) eliminating the marriage penalty, (3) reforming the international tax system by moving to a territorial system, (4) permitting full expensing of all capital expenditures, and (5) completely eliminating the IRS and replacing it with “a new, smaller, and more accountable department at the Treasury.” The RSC study paper also recommends that Congress enact H.R. 27, the Tax Code Termination Act, which would eliminate the Internal Revenue Code in 2019 (with the expectation that this would force Congress to enact a replacement code before that date).

As part of the RSC’s efforts, Chairman Kevin Brady (R-TX) has instructed Representative Charles Boustany (R-LA), chairman of the Tax Policy subcommittee, to oversee the efforts to produce a consensus blueprint for tax reform. Representative Boustany’s subcommittee is expected to release the high-level blueprint later this month. When it is released, it is unlikely to contain a revised draft of the “innovation box” proposal that Representatives Boustany and Richard Neal (D-MA) introduced in 2015.

Other members of the Ways & Means Committee are moving forward with their own ideas for reform—Representative Jim Renacci (R-OH) announced at the end of May that he intends to introduce a tax reform plan in the next few weeks. Representative Renacci’s plan, which is expected to be a white paper and not draft legislation, would replace the corporate income tax with a single-digit tax on business activities. Representative Renacci’s plan is also expected to include a consumption tax.

While the House Republicans work on blueprints for reform and consider consumption taxes as part of the Republican Party platform, Representative Sander Levin (D-MI) introduced an anti-inversion bill (for the third time this Congressional session) in mid-May. Representative Levin’s bill, which has no hope of passage in a Republican-controlled Congress, would limit hopscotch loans and de-controlling CFCs. His bill can be seen as part of a messaging effort by Democrats that one of their goals for tax reform is to “close loopholes.”

The Senate

In the Senate, Senators Orrin Hatch (R-UT) and Ron Wyden (D-OR) appear to be on completely divergent paths. Senator Hatch is pursuing corporate integration, while Senator Wyden released two discussion drafts, one on cost recovery reform and simplification, and the other on the taxation of derivatives. Senator Hatch has been working on his corporate integration proposal since at least 2014, when his staff released a white paper titled, *Comprehensive Tax Reform for 2015 and Beyond*, nearly a third of which focused on corporate integration.

Although Senator Hatch has announced that he will not release his proposal until later in June, the Senate Finance Committee held two hearings on corporate integration in May. During the hearings, Senator Hatch explained that his plan will provide corporations with a dividends-paid deduction and will impose a non-refundable withholding tax on dividends and interest paid to shareholders (including foreign and tax-exempt shareholders). While Senator Hatch said that the Joint Committee on Taxation has scored his plan as revenue positive, he intends to revise it to be revenue-neutral. Baker & McKenzie partner John McDonald testified at the second hearing about the merits of shifting the burden of tax from highly mobile corporations to their less-mobile shareholders via corporate integration. McDonald noted that the benefits of a dividends-paid deduction include reducing the incentive for US multinationals to produce products or services offshore, the existing lock-out effect for offshore cash, and the current preference for debt financing. His testimony also identified considerations that Senator Hatch and the Committee should take into account in designing a corporate integration system.

The hearings demonstrated that other members of Senate Finance—including other Republicans—have significant questions about Senator Hatch's proposal, including how a withholding tax on dividends and interest paid to pension plans would impact Americans' ability to save for retirement, the effect of corporate integration on credits for economic growth (such as the R&D credit, New Markets Tax Credit, and historic rehabilitation credit), and whether corporate integration would exacerbate corporate managers' perceived preference for short-term benefits over long-term investments in physical assets and human capital. Moreover, some witnesses stated that they believe that a withholding tax on dividends and interest paid to foreign persons could violate the United States' tax treaties, although Senator Hatch vigorously denied this assertion. Regardless, it seems unlikely that the corporate integration proposal, once introduced, will find immediate support among other members of the Senate Finance Committee.

Meanwhile, Senator Wyden introduced legislation on April 26 that would replace the existing cost recovery system with an Accelerated Mass Asset Cost Recovery and Reinvestment System ("A-MACRRS"). The summary of the discussion draft notes that, under current law, there are more than one hundred depreciation schedules and a single asset can be depreciated in multiple ways. Under A-MACRRS:

- Machinery and equipment would be combined into six pools, based on current accelerated depreciation schedules, and taxpayers would compute depreciation with six calculations for their business under a single method;
- Access to tax-free reinvestment benefits would be expanded to all machinery and equipment in the same pool, without the application of the current like-kind rules;
- The half-year and mid-month accounting rules for machinery and equipment would be repealed; and
- Treasury would be granted authority, subject to Congressional oversight, to update asset lives to account for new technologies.

The discussion draft requires Treasury to review the overall depreciation system and submit a report to Congress every five years, and is revenue-neutral. Senator Wyden has requested comments on the discussion draft and on additional issues, including (1) transition rules, (2) proposals to provide relief for abandoned property and property with a low disposition value, (3) whether pooled depreciation should be extended to Code Section 179 property, and (4) the need to maintain the alternative minimum tax ("AMT") and like-kind exchange provisions.

In mid-May, Senator Wyden introduced a discussion draft, the Modernization of Derivatives Tax Act of 2016, simplifying the taxation of derivatives by marking derivatives to market and treating any gain or loss as ordinary gain or loss. The discussion draft defines a derivative as "any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (1) Any share of stock in a corporation, (2) Any partnership or beneficial ownership interest in a partnership or trust, (3) Any evidence of indebtedness, (4) Except as provided [in section 493(b)(1) of the discussion draft], any real property, (5) Any commodity which is actively traded (within the meaning of section 1092(d)(1)), (6) Any currency, (7) Any rate, price, amount, index, formula, or algorithm, (8) Any other item as the Secretary may prescribe." Items one through eight are excluded from the definition of a derivative.

Taxpayers are expected to use sources of information and valuation methods consistently from period to period in determining the fair market value of derivatives (while incorporating financial market developments and advances in financial engineering fairly and reasonably). As a result, taxpayers are permitted to rely on valuations that brokers provide under section 6045(b). While taxpayers may rely on non-tax reports and statements to value derivatives, the discussion draft provides an ordering rule to prioritize the use of applicable financial statements. While the discussion draft would be effective for taxable events occurring 90 days after the date of enactment, the draft contains transition rules for derivatives and underlying investments held at the close of that 90-day period. The Joint Committee on Taxation estimated that Senator Wyden's derivatives legislation would raise $16 billion over a decade.

Senator Wyden will likely release more discussion drafts to set the table for tax reform. These drafts may become increasingly important if the Democrats take control of the Senate after the November 2016 election.

President Obama's Final Statement on Business Tax Reform?

Not to be left out, the White House and the Treasury Department released *The President's Framework for Business Tax Reform: An Update* on April 4, 2016 ("the Framework"). The Framework was generally overlooked because it was released on the same day as the temporary regulations under Code Section 7874 addressing inversions and the proposed debt-equity regulations under Code Section 385 (for a full discussion of these regulations, please see previously released Tax Client Alerts, *Treasury Issues Temporary Regulations on Inversions,* distributed May 3, 2016, and *Proposed Regulations Under Code Section 385*, distributed April 19, 2016, available under insights at www.bakermckenzie.com), but it contains several ideas seen in the President's 2012 Framework and recent Budgets, including:

1. A 19% minimum tax on foreign earnings and a one-time 14% tax on unrepatriated earnings (which would be spent on infrastructure investment), and

2. Cutting the corporate tax rate to 28%, which would be paid for by broadening the base by scaling back depreciation, reducing the preference for debt financing, and eliminating "dozens" of business tax loopholes and expenditures (including LIFO).

The Framework is highly critical of an innovation box, calling it "just another variation on a race to the bottom in the taxation of multinational firms." Instead, the Framework proposes making additional simplifications to the R&E credit, making the production tax credit refundable, and reforming the domestic production activities deduction by cutting the corporate tax rate for manufacturing income to 25%. Finally, the Framework contains several proposals related to Wall Street that are broader than tax policy, including imposing a financial transaction fee and increasing the budget and size for non-tax market regulators like the Commodities Futures Trading Commission and the Securities and Exchange Commission.

Observations

These disparate approaches demonstrate that, while calls for tax reform continue, there is little consensus about how to achieve tax reform. These differences, coupled with a Presidential election in November, virtually eliminate the chances for tax reform in 2016. However, the direction and timing of tax reform will depend on the outcome of the Presidential and Congressional elections. The Congressional tax writing committees will devote significant time this year to refining their proposals, and this is the year for stakeholders to engage.

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

Senate Finance Committee Advances Legislation Overturning Temporary IRS Regulations Allowing the Use of Outside Counsel

On April 18, 2016, Senator Rob Portman introduced S. 2809, a nine-page bill, “to preserve taxpayers’ rights to administrative appeal of deficiency determinations, and for other purposes.” Notwithstanding its brevity, the introduction of S. 2809 represented a significant push-back on aggressive tactics employed by the IRS’s Large Business and International Division in recent transfer pricing examinations.

Two days later, the Senate Finance Committee approved the Taxpayer Protection Act of 2016, as modified and amended, which included the portion of S. 2809 overturning Treas. Reg. § 301.7602-1T. These temporary regulations purport to authorize contractors to participate fully in the conduct of an examination, including the use of outside counsel to take sworn testimony in summons interviews.

Limiting the IRS’s Ability to Outsource Tax Examinations

S. 2809 bars the IRS from delegating to third-party contractors the authority to examine books and records, summons persons or take sworn testimony related to a tax matter. This provision effectively invalidates Treas. Reg. § 301.7602-1T, issued on July 7, 2014, which purports to authorize contractors to participate fully in the conduct of an examination, including the use of outside counsel to take sworn testimony in summons interviews.

Ensuring Access to Appeals

S. 2809 guarantees a taxpayer’s right to access Appeals, prior to the issuance of a notice of deficiency, so long as: (i) the taxpayer’s position is not frivolous; (ii) the case has not been designated for litigation; and (iii) at least 60 days remains on the statute of limitations. While a case that has been designated for litigation is exempted from this rule, S. 2809 limits litigation designations to “listed transactions” under Code Section 6707A(c)(2). Moreover, S. 2809 requires the IRS to send a case to Appeals, even if less than 60 days remains open on the statute of limitations, so long as the taxpayer agrees to extend the statute of limitations for an additional year.

Limiting the IRS’s Ability to Issue Designated Summonses

The designated summons rules, set forth in Code Section 6503(j), provide that the IRS can unilaterally suspend the statute of limitations on assessment by bringing a district court proceeding to enforce a designated (or a related) summons. While the statute is silent on whether a lack of taxpayer cooperation is a condition precedent to a valid designated summons, the legislative history reveals that Congress’ dual purpose in enacting the designated summons rules was to prevent recalcitrant taxpayers from balking at routine information and document requests while still enjoying the benefit of the running of the statute of limitations on assessment, and, at the same time, to protect cooperative taxpayers from uncertainty and unjustified suspension of the statute of limitations. *See* H.R. Rep. No. 101-881, at 310 (1990), *reprinted in* 1990 U.S.C.C.A.N. 2017, 2312.

S. 2809, consistent with this prior legislative history, makes clear that the issuance of a designated summons is contingent upon the taxpayer's failure to cooperate with "reasonable requests" for "witnesses, documents, meetings, and interviews." S. 2809 also requires a review and written approval by IRS and Office of Chief Counsel executives that "clearly establishes" lack of reasonable taxpayer cooperation, and further requires that this review and written approval be attached to the designated summons.

The Taxpayer Protection Act of 2016, S. 2809 Current Status, and Next Steps

On April 20, the Senate Finance Committee approved The Taxpayer Protection Act of 2016, as modified and amended, which includes the provision from S. 2809 barring the IRS from delegating authority to third-party contractors under section 7602. The other provisions of S. 2809 were not included.

S. 2809 remains a stand-alone piece of legislation and, it is unclear when the Senate Finance Committee will take further action. Nevertheless, the Senate Finance Committee has demonstrated strong interest in preparing legislative language, particularly as it relates to tax administration, and taxpayers should stay tuned for further developments.

By Daniel A. Rosen, New York and Alexandra Minkovich, Washington, DC

2015 Competent Authority Statistics Show Uptick in Settlements; Increased Inventory

The IRS released its 2015 report of competent authority statistics on April 27, 2016, which showed continuing strong performance in settling cases (an increase of almost 50% over 2014, due in part to a targeted effort to resolve a large portion of the pending cases with India) and a significant number of newly filed requests, which has been trending upward since 2010. New cases involving foreign-initiated adjustments continue to outnumber US-initiated adjustments, representing almost 80% of pending inventory. Given the increase in audits around the globe triggered by the OECD Base Erosion and Profit Shifting ("BEPS") initiative, that number is expected to continue to rise, putting more pressure on an office that, despite the increased number of closed cases, has seen its total inventory more than double in the past five years.

The competent authority process continues to provide full relief from double taxation in nearly all cases, with almost 95% of the total dollar adjustments at issue being settled with either full withdrawal by the initiating tax authority, full correlative relief provided by the receiving tax authority, or a compromise of both withdrawal and correlative relief. It is interesting to note that with regard to US-initiated adjustments settled in 2015, more than half of the dollars at issue (54%) were withdrawn by the IRS, as compared with 11% in 2014 and only 5% in 2013, the first year for which that specific data was segmented between US and non-US adjustments. It is not clear whether the withdrawals occurred unilaterally as a result of competent authority's review of the request for assistance, or as a bilateral agreement following discussions with the treaty partners, but in either situation this trend is a positive one for those taxpayers that are subject to IRS transfer pricing audit adjustments. With the changes to the simultaneous appeals process included in the competent authority revenue procedure released in 2015 (Rev. Proc. 2015-40), which require taxpayers to access competent authority and

Appeals simultaneously in order to protect their competent authority remedy, it is possible that this trend will continue. That is, US adjustments that in the past might have been withdrawn by the Appeals function, in whole or in part, will be included in the competent authority statistics going forward.

Finally, the average processing time for competent authority requests increased substantially between 2014 and 2015, from an average of 21 months to an average of 32 months. It is not clear whether this is a trend, however, since as noted above the competent authority office in 2015 made an effort to clear out a large number of Indian cases that had been in inventory throughout the period when the United States and India were not engaging in negotiations. Settlement of these cases could have artificially increased the average. In light of the substantial increase in cases needing resolution, however, it will bear watching whether this is an outlier or a sign of a more permanent trend towards longer periods between submission and resolution.

By Barbara J. Mantegani, Washington, DC

Federal Court Holds Delaware Unclaimed Property Audits “Shock the Conscience”

On June 28, 2016, arguably one of the greatest current overreaches by a state government was dealt a significant blow. In *Temple-Inland, Inc. v. Cook*, the United States District Court for the District of Delaware declared many of the most controversial aspects of Delaware’s enforcement of its unclaimed property laws to be unconstitutional.

For the last decade Delaware has increasingly seen its unclaimed property laws as a source of revenue. The district court emphasized this fact in the opening paragraphs of its opinion, citing Delaware’s fiscal demands and “lax” enforcement of its unclaimed property laws as driving forces behind the dispute. The court went on to find a number of the state’s practices “shocked the conscience” in violation of Temple-Inland’s substantive Due Process rights. The state failed to conduct an audit for 22 years, ignored the otherwise applicable six year statute of limitations, gave no notice that relevant records should be retained for such an extended period, applied its estimation statute retroactively for no purpose other than raising revenue, used an estimation methodology that was fundamentally flawed in that much of the property used in the estimate was not owed to Delaware, and imposed multiple liabilities for the same property.

Companies currently under audit by Delaware and its contract auditors should consider proactive action, such as seeking an injunction to stay the audit. Companies that already have been coerced into paying funds that could not even arguably be due and owing to Delaware should consider seeking a refund. Given Delaware’s unconstitutional practices, significant funds may be recoverable. Baker & McKenzie’s State and Local Tax practice is preparing a client alert, to be distributed shortly, which will discuss in detail the implications of the district court’s opinion.

By Matthew S. Mock, Chicago

CheckFree Services' Secret Sauce Not Subject to Texas Sales Tax

The Texas Comptroller has traditionally taken a broad view of what constitutes a taxable "data processing service." However, one recent Texas Court of Appeals decision rebuked this interpretation with a ruling that presents wide-ranging implications in Texas. This decision, *Hegar v. CheckFree Services Corp.*, No. 14-15-00027-CV (Tex. App.—Houston [14th Dist.], Apr. 19, 2016, no pet. h.), narrows the breadth of what constitutes taxable "data processing services" for Texas sales tax purposes.

Taxation of Services in Texas

Although Texas sales tax applies to most sales of tangible property in Texas, the only services taxed are those specifically enumerated in the Texas Tax Code. There are 17 of these taxable services listed in Tex. Tax Code Ann. § 151.0101. This list includes a wide range of different services, some of which are easily understood and others which are more amorphous. A few of the more easily understood services include cable television services, motor vehicle parking services, and insurance services; others, which are more difficult to define, include real property services, personal services and "data processing services."

Under Texas law a "data processing service" includes "word processing, data entry, data retrieval, data search, information compilation, payroll and business accounting data production . . . and other computerized data and information storage or manipulation." Tex. Tax Code Ann. § 151.0035. A "data processing service" is also considered to include "the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or computer time or by the beneficiary of the service." The Comptroller has historically interpreted data processing services broadly on audit, which has been a source of consternation for many Texas taxpayers.

Interpretation of "Data Processing Services" Under CheckFree Services

In *CheckFree Services* the taxpayer, CheckFree Services ("CheckFree"), offered a suite of electronic financial services to banks, including an online bill pay service that enabled the banks' customers to electronically transfer money to selected payees. These services included the preparation of numerous reports containing detailed information regarding the customer users and processed payments during report periods, as well as bill summaries. CheckFree retained users' billing and payment data for user retrieval for 90 days, and stored the data for seven years in accordance with banking regulations. The Comptroller contended that these services were taxable data processing services and assessed sales tax on several services provided by CheckFree by imposing tax on CheckFree's "invoiced charges for monthly infrastructure fees; fees for paper and electronic transactions; processing charges for new subscriber set-ups; processing charges for non-sufficient funds, stop payments, and claims; subscriber fees for active and inactive users; subscriber fees for banking and bill pay; monthly minimum charges; service hosting fees; processing charges for telecommunications minutes and VPN lines; and transaction fees for excess payments and excess sessions."

At trial, the District Court was primarily concerned with whether CheckFree's transactions should be considered non-taxable bill pay services or taxable data processing services. Ultimately, the court looked to "the 'essence of the transaction' at issue, rather than simply the involvement of a computer, to determine the nature of the services CheckFree provided" and reviewed whether CheckFree's services were limited to compiling, entering, retrieving and maintaining information or if they were professional services that happened to use a computer in the course of performing those services. In ruling in favor of CheckFree, the court found that CheckFree employed a cadre of skilled professionals who performed professional services related to bill payment and noted that its finding that their services constituted more than simple data processing was supported by testimony that CheckFree's employees "are not a minor part of the bill pay service delivery; instead, they are the 'secret sauce' of the service." The court also found that the delivery platform used by CheckFree for the bill pay service is not the services sold by CheckFree and that the activities that the Comptroller contended to be data processing were merely incidental services to the non-taxable bill pay services sold by CheckFree.

On appeal, the Texas Court of Appeals affirmed the District Court's decision, stating that although "the Comptroller has been granted exclusive jurisdiction to interpret what 'taxable services,' including 'data processing services,' means, the Comptroller may not interpret this term in a manner contrary to the tax code." The Court of Appeals accepted the District Court's findings and focused on the express language of the statute and regulations, pointing out that for a service to be taxable under 34 Tex. Admin. Code § 3.330(a), the processing of information must be "*for the purpose of* compiling and producing records of transactions, maintaining information, [or] entering and retrieving information." The Court of Appeals rejected the Comptroller's position that "because the users of the bill pay service input data into CheckFree's system, which CheckFree relied on to ultimately pay their bills, CheckFree was selling taxable data processing services to the banks." The Court of Appeals relied upon the District Court's findings of fact and concluded CheckFree's services did not constitute taxable data processing because the processing of information was an ancillary effect, rather than a primary purpose, of the services CheckFree provided.

Importance to Taxpayers

The decision is significant because by ruling that not every service involving a computer automatically falls under the taxable umbrella of "data processing services," the Court has drawn a boundary around what is actually included in "data processing services." The Texas Court of Appeals specifically pointed out that a taxable data service requires information to be processed for the intended purpose of compiling and producing records of information, maintaining information, and entering and retrieving information. Here, the Court found that "to the extent CheckFree provided any. . .[data processing services], they were ancillary to the professional bill pay services provided by CheckFree for the bank's customers-the electronic commerce services that the bank purchased from CheckFree." This finding that such services are not taxable is a far more narrow interpretation of Tex. Tax Code Ann. § 151.0101 than the Comptroller's interpretation.

Under the Comptroller's position, almost any type of information entered into a computer, for most purposes, constitutes a form of data entry that qualifies as a data processing service. The Court of Appeals strikes down that position, specifying that to qualify as a data processing service, the purpose of the data entry, i.e., the "essence of the transaction," must be to specifically enter the data for the purpose of data input or compilation of data, rather than entering data as part of a broader service or suite of services.

The Court recognized that the act of transmitting an online payment was the ultimate service offered, and without entering data to complete a consumer's transaction there is no way that the service could be provided. At the same time, the Court recognized that the primary purpose of this online payment and related data entry was not to enter or compile data on an electronic source, which would have triggered the sales tax on data processing services. This is an important distinction that narrows the applicability of the data processing services sales tax to services for the particular purpose of entering or compiling data. This ruling has not yet been appealed by the Comptroller. It will be interesting to see whether the Comptroller appeals the decision and if he continues to adopt an expansive view of data processing services after the final disposition of this case.

By Stephen W. Long and James M. Lucas, Dallas

South Dakota and Alabama Hatch *Newegg* Challenges to *Quill*

The bright-line physical presence nexus standard established by the US Supreme Court in *Quill v. North Dakota*, 504 U.S. 298 (1992) for sales and use tax purposes is under attack. Under this standard, a company must have a physical presence within a state in order for such state to constitutionally impose its sales or use tax upon that company. If such in-state physical presence does not exist, the imposition of tax is unconstitutional because it fails the "substantial nexus" requirement of the Commerce Clause. This has been the rule for the past 24 years, but now, in response to Justice Kennedy's concurring opinion in *Direct Marketing Association v. Brohl*, Dkt. 13-1032 (U.S. 2015) advocating for a reconsideration of *Quill*, South Dakota and Alabama have enacted controversial sales and use tax nexus laws designed to directly conflict with the US Supreme Court's holding in *Quill*. Both states have found companies willing to challenge them, including Newegg, Inc., a company that has been targeted by both states in their attempts to overturn *Quill*. For additional background on the events leading up to each state's change, please refer to the prior *Tax News and Developments* article States on the Verge of a Nexus Showdown (Vol. 16, Issue 2, April 2016).

South Dakota Economic Nexus Law is the Subject of Two Lawsuits

On March 22, 2016, South Dakota Governor Dennis Daugaard signed S.B. 106 into law, which became effective May 1, 2016. Under S.B. 106, any out-of-state seller selling tangible personal property, products transferred electronically, or services for delivery in South Dakota has nexus with the state for sales tax purposes, if South Dakota gross revenues from the aforementioned sales exceed $100,000 or if the seller made 200 or more separate transactions for delivery in South Dakota. This standard is much lower than the *Quill* standard, as it can be satisfied by a seller that does not maintain a physical presence in South Dakota.

Prior to the May 1, 2016 effective date, the South Dakota Department of Revenue allegedly notified 206 out-of-state retailers that they had until April 25, 2016 to either register with the state or notify the state that they were exempt because they fell under the thresholds. On April 28, 2016, South Dakota filed an action for declaratory judgment pursuant to S.B. 106 in South Dakota Circuit Court against four online retailers that do not have a direct physical presence in South Dakota: Wayfair, Inc., Systemax, Inc., Overstock.com, Inc., and Newegg, Inc. In its complaint, the state acknowledged that a ruling in its favor requires abrogation of *Quill* by the US Supreme Court.

The filing of South Dakota's complaint automatically triggered an injunction of the enforcement of S.B. 106 in effect during the pendency of the action, "prohibiting any state entity from enforcing the obligation in section 1 of this Act [i.e., taxation pursuant to the S.B. 106 nexus standard] against any taxpayer who does not affirmatively consent or otherwise remit the sales tax on a voluntary basis." S.B. 106 at § 3. If South Dakota ultimately prevails in its action, it may assess tax pursuant to the S.B. 106 nexus standard only on a prospective basis from the date the injunction is lifted or dissolved. *Id*. at § 6.

A mere day after the South Dakota Department of Revenue filed its suit, the American Catalog Mailers Association ("ACMA") and NetChoice, trade associations representing catalog marketers and e-commerce retailers, respectively, also filed a complaint for declaratory judgment, seeking a determination that S.B. 106 is in direct violation of *Quill* and is unconstitutional under both the Commerce Clause and Due Process Clause of the US Constitution.

Alabama and the *Newegg* challenge

Alabama's challenge to *Quill* is in the form of a regulation that became effective January 1, 2016. *See* Ala. Admin. Code 810-6-2.90.03. Pursuant to this regulation, out-of-state sellers without an Alabama physical presence are deemed to "have a substantial economic presence in Alabama for sales and use tax purposes and are required to register for a license with the Department and to collect and remit tax" when (1) such seller's retail sales of tangible personal property to Alabama customers exceed $250,000 per year based on the previous year's sales and (2) the seller conducts one of the activities enumerated in Ala. Code § 40-23-68 (e.g., soliciting orders of tangible personal property in Alabama by means of catalogs, commercials on cable television, or a telecommunication or television shopping system). Ala. Admin. Code 810-6-2.90.03(1).

Even though only a few reporting months have transpired since the new regulation became effective, the Alabama Department of Revenue has reportedly issued approximately 10 final sales and use tax assessments under the new economic nexus rule as of May 2016. Its efforts have not gone unnoticed. On June 9, 2016, Newegg, Inc. filed an appeal with the Alabama Tax Tribunal challenging Alabama's economic nexus regulation on Commerce Clause nexus grounds.

Beyond the fact that Alabama's economic nexus regulation is unconstitutional pursuant to *Quill*, Alabama's application of an economic nexus standard for sales tax purposes raises significant questions of legitimacy because it came in the form of an administrative rule change by the Alabama Department of Revenue as opposed to legislative action. Administrative agencies are charged with administering the laws of a state, not creating new ones outside the scope of the state statutes or federal law. But that finer point of governance may be lost on the Alabama Department of Revenue, which issued a statement upon the filing of

Newegg, Inc.'s appeal, stating that "In response to decades of Congressional inaction, the regulation was designed to directly challenge *Quill v. North Dakota*, a case decided by the U.S. Supreme Court in the early 90s, and its requirement that a remote seller have physical presence in a state for the state to requires the seller to collect its tax." The statement concludes with a quote from Alabama Revenue Commissioner Julie Magee, stating, "Until Congress acts, we will continue to lead the charge to overturn *Quill*."

Possible US Supreme Court Review

Although both South Dakota and Alabama have their sights set on overturning *Quill*, they face significant hurdles to achieve their goal. Convincing the U.S. Supreme Court to grant a petition for certiorari could potentially be difficult notwithstanding Kennedy's concurrence in *DMA*. Then, convincing the Court to overrule decades of established precedent in this area of the law, thereby violating the principle of and the Court's strong inclination toward *stare decisis*, would prove even more difficult. It could be that Congress, and not the courts, will have the final say on the taxation of remote sales.

By John Paek, Palo Alto and Roman Patzner, Chicago

Five Things You Need to Know About the New York State Draft Combined Reporting Regulations

Beginning in October 2015, the New York State Department of Taxation and Finance has been releasing draft regulations that will implement New York's extensive corporate franchise tax reform. Currently, the draft regulations address the following topics: nexus; sourcing of other services and other business receipts; sourcing of receipts from sales of digital products; discretionary adjustments; and combined reports. (The regulations addressing nexus, sourcing of other services and other business receipts, and sourcing of receipts from sales of digital products are discussed in detail in a prior article entitled *New York's 'Reformed' Regulations*.)

The combined reporting regulations address certain questions on indirect ownership or control; discuss the unitary business requirement; address instant unity and passive holding companies; and contain a curious grant of discretionary authority from the Department to itself to disregard certain commonly owned group elections. Maria Eberle and Lindsay LaCava examine these important aspects of the combined reporting regulations in their article, *Five Things You Need to Know About the New York State Draft Combined Reporting Regulations*. This article originally appeared in the April 29, 2016 issue of Bloomberg BNA's Tax Management Weekly State Tax Report and is also available under insights at www.bakermckenzie.com.

Canadian Tax Update

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

Supreme Court of Canada Income Tax Cases Confirm Strong Constitutional Protection for Solicitor-Client Privilege

Two recent Supreme Court of Canada decisions, *Canada v. Chambre des notaires du Québec*, 2016 SCC 20, and *Canada v. Thompson*, 2016 SCC 21, confirm that a client's right to solicitor-client privilege applies *prima facie* to shield a lawyer's accounting records (including invoices and any other records disclosing facts about the client relationship) from disclosure to the Canada Revenue Agency ("CRA"). The constitutionally-protected privilege cannot be abrogated by the CRA's extensive audit and enforcement powers unless "absolutely necessary." These cases are particularly significant because they uphold the blanket nature of the privilege in the face of a specific legislative attempt to carve away from that right in the context of Canada's federal tax laws.

The CRA has broad powers to require individuals to provide information and documents in the course of an audit or enforcement action. For example, the CRA may compel production of "any information" or "any document" for "any" purpose related to the administration or enforcement of the Canadian *Income Tax Act*, *Excise Tax Act*, or a Canadian tax treaty. This includes information and documents relating to third parties. Where a person fails to comply with a CRA requirement for information or documents, the CRA may obtain a court order requiring compliance. Failure to comply with a CRA requirement or the resulting court order may lead to the imposition of significant monetary penalties, conviction for contempt of court or imprisonment.

A statutory exception to the CRA's requirement power exists for information and documents protected by solicitor-client privilege. In general terms, solicitor-client privilege is a client's right to have communications with their lawyer kept confidential. This privilege developed initially as an evidentiary and common law rule, but it is unique in that it is today considered to be a fundamental constitutionally-protected right; no similar protection exists in Canada for communications with other legal or tax advisors (unlike US tax practitioner privilege). However, certain Canadian tax statutes include a definition of solicitor-client privilege in their respective audit requirement regimes that explicitly excludes a lawyer's "accounting records."

Chambre des notaires considered the CRA's practice of issuing requirements to civil law notaries in Québec (equivalent to lawyers in this respect) to obtain accounting records relating to their clients. The *Thompson* case involved a CRA request for details concerning a lawyer's accounts receivable in the course of auditing the lawyer for tax compliance. Naturally, solicitor-client privilege issues were raised in both cases, and both proceeded through two levels of Canadian courts before being accepted for hearing by the Supreme Court of Canada.

The Supreme Court held that both the requirement scheme and the legislative attempt at excluding a lawyer's accounting records from the concept of solicitor-client privilege were unconstitutional and invalid as applicable to lawyers and notaries. With respect to the requirement provisions, the Supreme Court determined that a requirement issued to a lawyer or notary for information or documents relating to a client was an unreasonable seizure (against which individuals enjoy constitutional protection). The limited statutory definition of solicitor-client privilege and the compliance order scheme improperly removed from a supervising court's jurisdiction the determination of whether accounting records sought by the CRA are privileged. While the Supreme Court's decision leaves open the possibility that the legislative scheme could be amended so as to acceptably address a lawyer's potentially-privileged accounting records, the Court stated that "any legislative provision that interferes with [solicitor-client privilege] more than is absolutely necessary will be labelled unreasonable." The Court's reasons suggest that a revised scheme would, at minimum, provide for notice to the client (when the CRA pushes the disclosure issue to court) and an opportunity for the client to fully assert solicitor-client privilege.

Chambre des notaires and *Thompson* therefore make clear the great importance of a client's right to solicitor-client privilege and its ability to remain free from government intrusion, even in the tax context where statutory rules often limit privacy rights in taxpayer information.

By Stephanie Dewey and Mark Tonkovich, Toronto

Treasury Issues Temporary Regulations on Inversions

On April 4, 2016, the US Department of Treasury issued extensive Temporary Regulations addressing inversion transactions and post-inversion planning. The Temporary Regulations incorporated, with some modifications, the rules announced in Notice 2014-52 and Notice 2015-79, and introduced new limitations on multiple-step acquisitions and "serial" acquisitions.

For a detailed description of the rules contained in the Temporary Regulations, including the new limitations on multiple-step acquisitions and "serial" acquisitions, please see previously released North America Tax Client Alert, *Treasury Issues Temporary Regulations on Inversions*, distributed May 3, 2016 and also available under insights at www.bakermckenzie.com.

Attorney-Client Privilege And A Law Firm Leak

In April, reports emerged of a massive leak of documents that appear to have been stolen from a non-US law firm. This is only the latest instance of confidential attorney files leaking into the public arena. The US Department of Justice has already announced that it is investigating potential violations of law. George M. Clarke, Trevor N. McFadden and Kathleen A. Agbayani examine these reports in their article, *Attorney-Client Privilege And A Law Firm Leak*, originally published by *Law360* on April 25, 2016. The article is also available at www.law360.com/articles/788633/attorney-client-privilege-and-a-law-firm-leak.

European Anti-Tax Avoidance Directive: Agreement Reached

On June 21, 2016, the European Council unanimously agreed on a package of anti-tax avoidance measures, known as the Anti Tax Avoidance Directive. This directive introduces at European Union level some of the OECD's BEPS Actions such as CFC and anti-hybrid rules, as well as an exit tax and a GAAR. The controversial "switch-over clause" has been dropped, and pre-June 17, 2016 finance arrangements are excluded from the new interest limitation rules. The new measures will apply throughout the EU from January 1, 2019. Since the Directive provides for minimum standards, Member States will inevitable implement the Directive provisions in different ways. This development is very relevant for US companies that have operations in the European Union, as they will need to monitor the implementation of this Directive in the various Member States as well as the impact thereof on their business structure in Europe.

For a detailed discussion of these measures, please see previously released Global Tax Client Alert, *European Anti-Tax Avoidance Directive: Agreement Reached*, distributed on June 22, 2016 and also available under insights at www.bakermckenzie.com.

IRS Issues Proposed Regulations Altering Compliance Requirements of Wholly Foreign Owned US Domestic Disregarded Entities

The IRS has issued proposed regulations altering the reporting requirements of disregarded entities that are wholly owned by a foreign person or a foreign entity. The regulations create reporting and record maintenance requirements for such entities similar to those which apply to 25% foreign-owned domestic corporations under Code Section 6038A. The proposed regulations create a significant reporting burden and raise privacy concerns.

The proposed regulations would require an affected entity to (1) file a Form 5472 information return and disclose certain reportable transactions between the entity and its foreign owner or other foreign related parties; (2) maintain sufficient records to establish the accuracy of the information return and the correct US tax treatment of such filing obligations; and (3) obtain an EIN and disclose information that includes identifying the responsible party.

For a full discussion on these final regulations, please see the previously released Tax Client Alert *IRS Issues Proposed Regulations Altering Compliance Requirements of Wholly Foreign Owned US Domestic Disregarded Entities distributed* on May 18, 2016 and also available under insights at www.bakermckenzie.com.

Getting Better All The Time…Baker & McKenzie Adds New Talent to its Partnership and Real Estate Tax Planning Practice

Recognizing choice of entity as an important component of every company's tax planning, Baker & McKenzie has recently added to the ranks of its existing partnership and real estate tax planning practice by adding two new partners in Chicago and Washington, DC.

Daniel Cullen returned to the Firm's Chicago office earlier this month as a Partner in the Tax practice, bringing with him nearly 20 years of experience advising clients on all aspects of federal tax planning for partnerships and other pass-through entities. He focuses his practice on inbound and outbound real estate projects, leveraged partnerships, joint ventures, REITs and other structures. He routinely advises on tax matters related to structured leases of real estate, aircraft, railcars, cell towers and other communications equipment. He counsels clients as well with regard to the tax aspects of derivatives and financial products.

Daniel serves as a REIT columnist for the *Journal of Passthrough Entities* and is viewed as an expert in the taxation of REITs, Delaware statutory trusts and related structures. He earned his J.D. from American University Washington College of Law and an LL.M. in tax from New York University School of Law.

Steven R. Schneider came on board recently as a Partner in the Washington, DC office. Having begun his career in the IRS Office of Chief Counsel, Steve has over 20 years of experience and is nationally recognized with broad-based transactional, controversy and tax policy experience. Steve's current practice focus is principally related to partnerships, REITs, S corporations, real estate, private equity and cross-border investment. He has significant experience advising clients on federal income tax issues related to international and domestic real estate acquisitions and dispositions, corporate joint ventures, partnership compensation structuring, partnership audits and service partnerships.

Steve has previously served as chair of ABA Tax Section's Partnerships and LLCs Committee, is a frequent public speaker, and has published numerous articles for *Taxes: The Tax Magazine, TaxNotes, Bloomberg BNA* and the *Journal of Taxation*, among many other publications. He earned his J.D. from Washington University School of Law and his LL.M. from Georgetown University Law Center, where he has been an adjunct professor since 2005, teaching an advanced tax course on drafting partnerships and LLC agreements.

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About Baker & McKenzie's Partnership, REIT and Pass-through Practice

Led by Richard Lipton in Chicago, the US-based team focuses on assisting clients in any number of industries that are choosing to conduct their business activities and hold their real estate and other investments in and through partnerships, limited liability companies, REITs, trusts, S corporations and other pass-through entities. The group regularly services large international clients on a wide variety of issues involving pass-through entities, including US real estate investment, and provides tax-efficient structuring solutions to inbound investors acquiring US real estate and other trades or businesses, and also advises US companies on outbound investments using pass-through entities. Industries served most recently include real estate, private equity, sports and entertainment, pharmaceuticals, alternative energy, software and information technology.

Baker & McKenzie and Bloomberg BNA Turn to Toronto and Hong Kong for Their Upcoming Transfer Pricing and International Tax Conferences

With the recent regulatory changes due to the OECD's BEPS Action Plan and the political and economic forces shaping the current tax landscape, Baker & McKenzie, alongside Bloomberg BNA, continues to bring essential thought leadership to clients and friends of our Firm. To that end, we invite you to join us August 29-31 in Toronto for the **Global Transfer Pricing Conference: Toronto** and **International Tax Conference: Canada**. Followed shortly thereafter by the fourth location in the conference series **Global Transfer Pricing: Asia** (Hong Kong - September 19-20), each conference brings together Baker & McKenzie tax practitioners, government officials and policy makers, and leading industry experts for a comprehensive analysis on the latest issues in transfer pricing and international tax.

Following successful events this spring in Paris and Washington, DC, Baker & McKenzie is excited to return with Bloomberg BNA to Toronto for their annual Global Transfer Pricing and International Tax Conferences, taking place on August 29-31 at the InterContinental Toronto Centre. Presenters will lead interactive discussions at each conference, addressing the changes to the international tax environment and what they mean for multinationals with Canadian operations. While the two-day Global Transfer Pricing Conference will cover specific transfer pricing issues, the International Tax Conference offers a broad analysis of the latest international tax issues.

Confirmed government speakers during the three day period include:

- Brian Ernewein, General Director, Tax Policy Branch, Department of Finance, Canada
- Carlos Achadinha, Legislative Chief, Department of Finance Canada, Tax Policy Branch, Sales Tax Division

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- Jennifer Ryan, Director, International Tax Division, International and Large Business Directorate, Canada Revenue Agency
- Michelle Levac, Transfer Pricing Specialist, Canada Revenue Agency
- Carlos Perez Gomez Serrano, Head of Transfer Pricing, Mexican Tax Authority

We hope to see you and your colleagues in Toronto! Those interested in attending either conference can find more information, including agendas, speakers and registration information, at www.bna.com/2016-global-transfer-pricing-toronto/. Register for the conferences using Baker & McKenzie corporate guest code to receive a reduced rate. Use **BAKTR16** when registering for the Global Transfer Pricing Conference to receive a reduced rate of $1,095 (regularly $1,395), and **BAKITC16** when registering for the International Tax Conference for the reduced rate of $595 (regularly $795).

Save the Date - Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference: Hong Kong

As multinationals doing business in China, India and other countries across Asia face new challenges navigating a tax environment increasingly demanding of transparency, Baker & McKenzie and Bloomberg BNA will conclude the **2016 Global Transfer Pricing Conference Series** with their Asia conference, to take place at the JW Marriott Hong Kong on September 19-20. The 2nd Annual Global Transfer Pricing Conference: Asia will provide insight into the most pressing and relevant transfer pricing issues faced by multinationals operating in Asia today. Topics include China's reaction to BEPS, managing global tax disputes, managing reputational risk over tax matters, India's new approach to transfer pricing, restructuring supply chains, and country-by-country reporting, among many others. For additional information and registration details visit http://www.bna.com/2016-global-transfer-pricing-hong-kong. To receive a reduced rate of $1,095 (regularly $1,395), use Baker & McKenzie corporate guest code **BAKHK16** at registration.

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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 Caylor at 312-861-8029 or marie.caylor@bakermckenzie.com.

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