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Understanding the 2016 Election Results and Their Impacts on Tax Reform

Although the 2016 election results caught political pundits, the Republican party, and tax reform observers by surprise, several questions now arise: What is the likelihood of tax reform? What will it look like? When will it occur? In this article, we'll look into our (admittedly cloudy) crystal ball to address those questions, as well as provide some useful information on what to watch during the transition from President Obama's administration to that of President-elect Trump.

Transition

President-elect Trump has announced the members of his "landing team" at Treasury, who will work with current Treasury officials to ensure a smooth transition from one administration to another. For tax purposes, notable members of the landing team include: Eileen O'Connor (former Assistant Attorney General at DOJ Tax during the George W. Bush administration), Curtis Dubay (currently a Research Fellow, Tax and Economic Policy at the Heritage Foundation), and Judy Shelton (an economist with her own consulting firm who has advocated for a return to the gold standard). The President-elect has tapped Jim Carter of Emerson as his transition team's point person on tax reform. In addition, Steven Mnuchin, a former Goldman Sachs partner and founder of the hedge fund Dune Capital Management, has been tapped as Trump's nominee for Treasury Secretary. At the time of writing, the President-elect had not announced his pick for the Assistant Secretary for Tax Policy. If history is any guide, these two individuals will play a significant role in tax reform and these appointments should be watched closely.

In the near term, the focus will be on regulatory developments. Congressional Republicans requested that President Obama cease issuing regulations, but the Administration ignored this request by issuing several tax regulations and other guidance, including regulations under section 987 and a notice addressing repatriation techniques (Notice 2016-73). It is unclear whether additional controversial regulations will be released before Inauguration Day. The ultimate fate of several controversial projects—such as the proposed 2704 regulations—is uncertain, as noted in the subsequent article in this issue, see *Even if the Proposed 2704 Regulations Don't Get Trumped, it May Not be as Bad as we Thought*, President-elect Trump has signaled that he would support repeal of the estate tax and replace it with a tax on death of unrealized appreciation on capital assets. We expect Treasury to continue working on those projects until instructed otherwise by the incoming administration.

Historically, incoming Presidents have issued an executive order "freezing" regulations that were finalized by their predecessor but had not yet become effective. In addition, President-elect Trump has announced that he will issue a "moratorium" on regulations. It is unclear whether this means he will issue the

Upcoming Tax Events

39th Annual North America Tax Conference

Toronto, Ontario
February 9, 2017

18th Annual Latin America Tax Conference

Miami, Florida
March 20-22, 2017

Baker McKenzie/Bloomberg BNA Global Transfer Pricing Conference

Paris, France
March 27-28, 2017

Financial Services Industry Tax Briefing Series

New York, New York
- March 27-28, 2017
- February 23, 2017
- May 2, 2017

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

traditional executive order or if his administration will refrain from issuing new regulations. In addition, options that would allow the President-elect to remove controversial final regulations (such as the section 385 regulations) include: (1) issuing a proposed rulemaking to withdraw final regulations (this is a time-consuming process that must follow traditional notice-and-comment procedures); and (2) under the Congressional Review Act, both house of Congress may pass a "resolution of disapproval" which, if signed by the President, invalidates final regulations issued near the end of a President's administration.

Prospects for Tax Reform

While a unified Republican government presents an opportunity for tax reform early in the next administration, Republicans have not yet reached consensus on what that reform should look like or whether reform should be a bipartisan endeavor. Several Republicans, including President-elect Trump, have expressed a preference for bipartisan tax reform, while others have suggested using "reconciliation" to pass tax reform. Reconciliation is a budget process that allows legislation to be passed with a simple majority (instead of a 60-vote filibuster-proof majority), making it an attractive vehicle for controversial legislation. However, reconciliation carries risks with it—most notably, anything passed through reconciliation cannot increase the deficit outside of the budget window (10 years), so any provisions that would increase the deficit automatically sunset after 10 years. The possibility that tax reform would sunset after 10 years undermines the certainty that legislators typically seek to achieve with tax reform and, if reconciliation were used, could create planning challenges for businesses.

In the Senate, Chairman Hatch has focused his attention on developing a corporate integration proposal. At the time this article was written, the proposal had not yet been announced, but Chairman Hatch is expected to propose a dividends-paid deduction, coupled with a 35% non-refundable withholding tax on interest and dividends paid to all shareholders (whether currently taxable or not). It is our understanding that the Joint Committee on Taxation has scored this proposal as revenue-neutral. This proposal is at odds with the direction taken by the House (which does not address corporate integration) and it is unclear how Chairman Hatch and the House will reach agreement on tax reform.

In the House, Speaker Ryan and Chairman Brady have focused their efforts on the House Republican Blueprint for Tax Reform. (The full text of the Blueprint is available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.) The House Republicans released the Blueprint in June as a high level document to set the principles and contours of tax reform for the election. Ways & Means majority staff are currently working to draft legislative language implementing the Blueprint, which we expect to be released in tranches in early 2017. The Blueprint describes comprehensive tax reform, and includes provisions for individuals, businesses, and "a new IRS for the 21st century."

With respect to businesses, the Blueprint would move the corporate income tax to a consumption tax. The Blueprint would lower the corporate income tax rate to 20%, repeal the AMT, provide for full and immediate expensing for all tangible and intangible assets (but not land), allow interest expenses to be deducted against interest income (but would prohibit current deductions for net interest

expense), allow NOLs to be carried forward indefinitely (but not carried back) and permit NOL carryforwards to be increased by an interest factor that compensates for inflation and a real return on capital, eliminate all “special interest” deductions and credits, and would preserve the R&D credit.

On the international side, the Blueprint would pivot to a “destination-basis” tax system and includes a border adjustment feature. Under the border adjustment provisions, products, services and intangibles exported outside the United States would be exempt from tax, while products, services and intangibles that are imported would be subject to US tax. It is likely that a cost of goods deduction would be denied for imports. Alternatively, a withholding tax could be applied to imports. Proponents of the border adjustability provision have argued that it will remove the incentive for companies to invert and will discourage overseas manufacturing, but retailers have expressed concern that it will increase their taxes (and the prices that they charge to consumers) substantially. Concern has been expressed that the border adjusted tax could be struck down by the World Trade Organization.

The Blueprint would impose a one-time “deemed” repatriation tax and, going forward, will replace our existing worldwide system with a territorial tax system. Overseas earnings that are held in cash or cash equivalents will be taxed at 8.75% under the deemed repatriation rules, and all other assets will be taxed at 3.5%. Businesses will have up to eight years to pay the resulting tax liability. Under the new territorial regime, there will be a 100% exemption for dividends from foreign subsidiaries and subpart F will be streamlined and simplified. All categories of subpart F would be repealed, except the foreign personal holding company category.

Finally, while President-elect Trump’s statements on the campaign trail indicated some overlap with the House Republican Blueprint, there were also significant areas of difference. Areas of overlap include a reduced corporate tax rate (although President-elect Trump has advocated for 15%), elimination of the corporate AMT, deemed repatriation of overseas earnings (President-elect Trump advocates a 10% rate), and the elimination of most corporate tax expenditures, other than R&D. President-elect Trump, however, may retain the worldwide tax system and has announced that he intends to use the funds raised from deemed repatriation to pay for infrastructure investments, rather than lowering the corporate tax rate and transitioning to a territorial system (as House Republicans would prefer). Investing the proceeds from deemed repatriation in infrastructure spending is an area where President-elect Trump’s views are in alignment with Senate Democrats, and this may be an area for bipartisan agreement. Moreover, on the individual income side of the Code, President-elect Trump advocated eliminating carried interest, an issue which the Blueprint does not address and which Congressional Democrats have historically championed.

While one of President-elect Trump's advisors recently suggested that Congress should focus on business tax reform only, instead of comprehensive tax reform, previous efforts to separate individual and business tax reform have failed because small businesses (which are largely organized as pass-throughs) objected to lower corporate rates in the face of high individual income tax rates. Any attempt to pursue business-only tax reform is likely to encounter similar political headwinds.

If tax reform is going to be a bipartisan enterprise, then buy-in will be needed from Senate Democrats. Although the Blueprint contains little that Senate Democrats may be willing to support, some of President-elect Trump's campaign promises—notably, eliminating carried interest and using repatriation proceeds to fund infrastructure—could find Democratic support. Some Senators, including Senators Sanders and Warren, have already expressed an interest in working with the President-elect on increased infrastructure spending. Senator Schumer, the incoming Senate minority leader, has a history of working on bipartisan tax proposals with Speaker Ryan and has long been a proponent of increased infrastructure spending.

At this point, it is premature to predict what tax reform will look like, whether it will be bipartisan, or when it will occur, although it is clear that a unified Republican government puts tax reform at its most likely in several years. Key developments to watch include President-elect Trump's pick for Assistant Secretary for Tax Policy, the negotiations between House Republicans and a new Trump administration, and whether and how Senate Democrats participate in those negotiations.

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

PLR 201643008: IRS Applies Expansion Doctrine When Corporation Proposes to Spin-Off Subsidiary that Holds Recently-Acquired Partnership Interest

In PLR 201643008, the IRS ruled that a distributing corporation had expanded its existing business when it acquired a partnership interest during the five-year period preceding a contemplated spin-off and had not acquired a new or different line of business that would be disregarded for purposes of the active business requirement of Code Section 355. The ruling is premised on two separate principles. First, partnership business activities may be attributed to a distributing or controlled corporation that owns a "significant" interest in the partnership. Second, if a distributing corporation conducts one business throughout the five-year period preceding a spin-off and acquires a second business that is part of the same line of business as the first, the acquisition represents an expansion and the second business is considered to have been conducted for the duration of that five-year period. This second principle is often referred to as the expansion doctrine. The ruling applies the expansion doctrine to business activities attributed from a partnership in the same manner as business activities directly conducted by the distributing or controlled corporation.

Overview of Rules and Authorities Relevant to the Ruling

To qualify as a tax-free spin-off, the distributing and controlled corporations must each be engaged in the active conduct of a trade or business immediately after the distribution, among other requirements. These trades or businesses must have been actively conducted throughout the five-year period preceding the distribution and generally must not have been acquired by the distributing or controlled corporation in a taxable transaction within that five-year period.

There are rules for attributing business activities of related parties to the distributing and controlled corporations. For instance, all members of the distributing or controlled corporation's "separate affiliated group"—generally including subsidiary corporations in which the distributing or controlled corporation owns, directly or indirectly, at least 80% of the voting power and value—are treated as one corporation. The relevant ownership threshold for attributing partnership business activities to its partners is lower. Under Rev. Rul. 2007-42, a corporation that owns a "significant" interest in a partnership is treated as engaged in the partnership's business even if the corporation does not directly conduct any activities relating to that business. In the revenue ruling, the IRS concluded that a 33.33% partnership interest is "significant," but that a 20% partnership interest is not.

In determining whether a corporation has conducted an active trade or business throughout the five-year period preceding a distribution, regulations distinguish between acquisitions that expand an existing business from acquisitions of a new or different business. An expansion of business activities occurs when the distributing or controlled corporation acquires a trade or business that is considered to be in the same line of business as a historic business. In the event of an expansion, the distributing or controlled corporation is considered to have conducted the newly-acquired trade or business for the same period of time that the historic business was conducted.

The Ruling

In PLR 201643008, a domestic corporation (Distributing) owned at least 33.33% of the membership interests in a limited liability company that was treated as a partnership for US tax purposes (LLC 1). Distributing acquired its LLC 1 interest more than five years before a proposed spin-off. Distributing represented (i) that its LLC 1 interest was "significant" within the meaning of Rev. Rul. 2007-42 and (ii) that LLC 1 had been engaged in the active conduct of Business A at all times during the five years preceding the proposed spin-off.

Distributing directly owned all of the stock in two domestic corporations (Sub 1 and Sub 2), which in turn owned various subsidiaries.

Distributing directly owned some of the membership interests in a second limited liability company that was treated as a partnership for US tax purposes (LLC 2). Distributing indirectly owned the remaining membership interests in LLC 2, which were directly held by subsidiaries of Sub 1 and Sub 2. Though not explicit in the facts, Distributing apparently acquired its LLC 2 interest (or at least a block of LLC 2 membership interests representing a "significant" interest in LLC 2) during the five years preceding the proposed distribution.

To facilitate and implement the spin-off of its directly and indirectly held LLC 2 interests, Distributing proposed the following steps. First, Distributing would create a new corporation (Controlled). Second, some of the LLC 2 interest held in the Sub 2 chain would be distributed, up the chain of corporate ownership in successive distributions, to Distributing. The effect of these lower-tier distributions would be to increase the proportion of LLC 2 interests that Distributing directly holds, but Distributing would nonetheless continue to hold some of the LLC 2 interests indirectly through other subsidiaries. Third, Distributing would contribute all of its directly-held LLC 2 interests and all of its Sub 1 stock (through which some of the remaining LLC 2 interests were held) to Controlled. Finally, Distributing would distribute all of its Controlled stock to its shareholders.

The IRS ruled only on a discrete issue, citing the rules discussed above and succinctly concluded that the Distributing group's acquisition of LLC 2 interests was an expansion of Distributing's Business A and did not constitute the acquisition of a new or different business. The taxpayer may have been worried that the expansion doctrine could not be applied to treat a newly-acquired business as an expansion of a preexisting business that Distributing was only considered to conduct by reason of holding a passive but "significant" interest in a partnership. PLR 201643008 suggests that there is no limitation on the expansion doctrine in the context of business activities deemed to be conducted through passive partnership investment, which is a conclusion consistent with the Code and Regulations that do not expressly provide to the contrary.

By Ross Staine, Houston

Analog Devices Reverses *BMC Software* on Section 965 Dividend Received Deduction

On November 22, 2016, the Tax Court, in a fully reviewed opinion upheld the taxpayer's Code Section 965 dividend received deduction. *Analog Devices, Inc., v. Commissioner*, 147 T.C. No. 15 (Nov. 22, 2016). As part of the American Jobs Creation Act of 2004, Congress enacted section 965 to attempt to stimulate the US economy by allowing US corporations to bring back earnings previously invested offshore to hire employees, engage in research and development activities and/or make capital investments in the United States. Congress incentivized US corporations to repatriate cash by allowing them to take a dividends-received deduction ("DRD") equaling 85% of an extraordinary dividend. Notably, section 965(b)(3) reduces the amount of the dividend eligible for the DRD by the excess of the amount of indebtedness of the CFC to any related person as of the close of the taxable year for which the 965 election is in effect less the amount of indebtedness of the CFC to any related person as of the close of October 3, 2004.

In *BMC Software Inc. v. Commissioner*, 141 T.C. No. 5 (Sept. 18, 2013), the Tax Court previously sided with the IRS over a taxpayer claiming a section 965 deduction. (See prior *Tax News and Developments* article, *BMC Software v. Commissioner: A "Catch-22" for Taxpayers Litigating Section 482 Controversies Arising from Years Also Including a Section 965 Repatriation* (Vol. 13, Issue 5, October 2013), available under insights at www.bakermckenzie.com). The Fifth Circuit Court of Appeals reversed the Tax Court in 2015. *BMC Software Inc. v.*

Commissioner, 780 F.3d 669 (5th Cir. 2015); (see prior *Tax News and Developments* article, Taxpayer Victory: Fifth Circuit Reverses Tax Court in BMC Software, Inc. v. Commissioner (Vol. 15, Issue 2, April 2015), available under insights at www.bakermckenzie.com). The Tax Court in *Analog Devices* rejected the prior Tax Court opinion in *BMC Software* and adopted the rationale in the Fifth Circuit's reversal of that opinion.

The issue in both *Analog Devices* and *BMC Software* involved the interaction between section 965(b)(3) related party indebtedness and accounts receivable established under Revenue Procedure 99-32, related to section 482 adjustments. Both taxpayers had agreed to a section 482 adjustment for tax years when they claimed the section 965 DRD. After resolving the section 482 adjustment, the taxpayers sought relief under Rev. Proc. 99-32 to establish accounts receivable to repatriate the amounts agreed upon for the primary section 482 adjustment. The taxpayers signed closing agreements with the IRS that: (a) established the accounts receivable; (b) agreed to pay interest on the amounts going back to the last day of the tax year of the adjustment; (c) agreed that the accounts were "deemed to have been created as of the last day of the taxable year to which it relates[,]"; and (d) did not address the treatment of the accounts under section 965(b)(3).

In Notice 2005-64, the IRS published a single cryptic sentence stating that "[a]ccounts payable established under Rev. Proc. 99-32, 1999-2 C.B. 296, in connection with section 482 adjustments are treated as indebtedness for purposes of section 965(b)(3)." In September 2008, the IRS released Advice Memorandum AM 2008-10. The Advice Memorandum stated that Rev. Proc. 99-32 closing agreements should include language to confirm that the accounts receivable were related party indebtedness under section 965(b)(3).

In *Analog Devices*, the Tax Court faced the decision of whether to follow its prior opinion or the Fifth Circuit's decision reversing the opinion. Chief Judge Marvel wrote the majority opinion. The Tax Court addressed whether it should follow its prior precedent under *stare decisis*. The Tax Court felt it was not bound by the prior opinion because of the Court of Appeals reversal and the prior opinion being an issue of first impression that had not been relied upon by any other court.

The majority opinion analyzed the closing agreement under general federal contract interpretation principles. The Court held that the language of the closing agreement only addressed limited tax consequences specifically enumerated by the parties. The Court held it determinative that the closing agreement did not address section 965 in any way and that failing to address section 965 showed the intent of the parties to not agree to the section 965 consequences.

The Court also addressed the extrinsic evidence of the parties' intent. The IRS argued that the taxpayer should have known the IRS would interpret the closing agreement as section 965(b)(3) related party indebtedness because of Notice 2005-64 and a notice of proposed adjustment raising the issue in connection with the section 482 issue. The Court rejected this position, stating that the taxpayer's disagreement with the IRS on the section 965 issue and the failure of the closing agreement to address the section 965 issue were determinative.

The Court analyzed the two BMC opinions and decided to follow the Fifth Circuit's opinion and hold for the taxpayer. The Court said that the closing agreement created the indebtedness well after the close of the tax year of the section 965 election.

Judge Gustafson wrote a dissenting opinion, joined by three judges. The dissent argued that the boilerplate language in the closing agreement, stating that the closing agreement "agreed, for all Federal income tax purposes . . ." was sufficient to give the accounts receivable full retroactive effect, including to be treated as related party indebtedness. The dissent saw a distinction from the closing agreement in *BMC Software*, as the Analog Devices closing agreement included "all" and BMC's did not. Judge Lauber wrote a concurring opinion arguing that "all" did not make a meaningful distinction between the agreements.

In the absence of a motion for reconsideration, the Tax Court will enter a decision in the favor of the taxpayer in the next few weeks. Following the entry of the final decision, the IRS will have to decide whether to appeal *Analog Devices* to the First Circuit.

By Robert S. Walton, Chicago

US Treasury Announces Final CFC/Partnership Regulations, Which are a lot like the Temporary Regulations

The United States Treasury issued final regulations on November 3, 2016 (the "Final Regulations") clarifying when a controlled foreign corporation ("CFC") is deemed to repatriate assets under Code Section 956 when transacting with partnerships. The Final Regulations implement few changes from the temporary and proposed regulations from September 2015. The most significant change increases the ways in which a CFC partner in a partnership may be treated as holding US property, respectively increasing the chance that the US shareholders of the CFC will have an income inclusion under section 951. The Final Regulations also obsolete Revenue Ruling 90-112 and specify that a partner's liquidation value percentage should determine both a CFC partner's share of partnership property and share of a partnership obligation.

Expanded Anti-Abuse Rule

The Final Regulations expand the scope of the section 956 anti-abuse rule in the September 2015 regulations. Consistent with the Temporary Regulations, the anti-abuse rule now applies if the CFC funds a controlled partnership and if a principal purpose of creating, organizing or funding by any means (including through capital contributions or debt) the partnership is to avoid the application of section 956 with respect to the CFC. For this purpose, a CFC controls a partnership if the CFC and the partnership are related within the meaning of section 267(b) or section 707(b). In addition, the anti-abuse rule extends to cases where the funding that was done for section 956-avoidance purposes was funding "by any means" other than capital contributions or debt. If the foregoing requirements are met, a CFC is treated as owning all of a controlled partnership's US property.

In addition, the Final Regulations expand a coordination rule preventing a CFC from being treated as holding duplicative amounts of United States property by reason of the anti-abuse rule of Treas. Reg. §1.956-1(b)(4) and the attribution rules of Treas. Reg. §1.956-4(b) or (c).

In a response to comments provided in respect of the Temporary Regulations, the Final Regulations now include examples illustrating that sales of property for cash in the ordinary course of business or a repayment of a note are not subject to the anti-abuse rule.

Calculation of Partner's Share of Partnership Property and Partnership Obligation: Liquidation Value Percentage

CFC Partner's Share of Partnership Property

In instances where the anti-abuse rule does not cause all of the partnership's property to be held by the CFC partner, the Final Regulations provide that the amount of US property attributed to a CFC partner from a partnership is determined by reference to the partner's liquidation value percentage ("LVP"). A partner's LVP is a percentage based on the amount of cash a partner would receive (relative to the aggregate cash received by all partners) if the partnership sold of all of its assets at fair market value, satisfied its liabilities, and liquidated. Consistent with the Proposed Regulations, the determination of a partner's LVP takes into account special allocations, provided the special allocation does not have a principal purpose of avoiding the application of section 956.

Generally, a partner's LVP must be re-determined upon a "revaluation" event specified in the section 704(b) regulations. Those events include certain contributions, distributions, issuances of compensatory equity, and exercises of partnership options and conversion rights. In response to comments that partners' relative economic interests in the partnership may change significantly as a result of allocations of income or other items under the partnership agreement even in the absence of a revaluation event, the Final Regulations provide that a partner's liquidation value percentage must be re-determined in certain additional circumstances. Specifically, if the LVP determined for any partner on the first day of the partnership's taxable year would differ from the most recently determined LVP of that partner by more than 10 percentage points, then the LVP must be re-determined on that day even in the absence of a revaluation event.

CFC Partner's Share of Partnership Obligations

The Final Regulations generally treat the obligations of a foreign partnership in which one or more partners are either the lending CFC or a person related (within the meaning of section 954(d)(3)) to the lending CFC as separate obligations of its partners by reference to each partner's LVP, and for this purpose, special allocations are not taken into consideration. As a result, if a CFC holds an obligation of a foreign partnership (e.g., the CFC loans money to the foreign partnership), and one or more of the partners is a US person that is related to the CFC, then the obligation will be treated as an obligation of a US

person, to the extent of that US person's LVP, for purposes of section 956, which could result in a section 956 inclusion by the US person. Consistent with the Proposed Regulations, the Final Regulations provide an exception to this general rule where neither the CFC that holds (or is treated as holding) the obligation nor any person related to such CFC (within the meaning of section 954(d)(3)) is a partner in the partnership on the CFC's quarterly measuring date under section 956.

The Final Regulations also provide that an obligation of a domestic partnership is in all cases treated as an obligation of a US person.

What Does This All Mean?

First, taxpayers should keep in mind the expanded anti-abuse rule provided by the Final Regulations. If a partnership is a 'controlled' foreign partnership (i.e., the partnership and the CFC are related within the meaning of section 267(b) and section 707(b)) and a principal purpose of creating, funding or organizing the partnership is to avoid the application of section 956, then the CFC is treated as owning all of the controlled partnership's U.S. property. In this context, proposed rules provide that special allocations are not taken into account for determining a partner's attributable share of controlled partnership property under the LVP approach, using an 80% test when applying the related party rules of section 267(b) or section 707(b) to determine control. Courts have historically been very generous to the IRS when determining what is a principal purpose. Moreover, the examples provided in the final regulations are not illustrative. It is merely stated in the examples that avoidance that a principal purpose of the planning is to avoid the application of section 956.

Second, as was the case with the recent final regulations issued pursuant to section 385, Treasury again equates partner's interest in a partnership with the liquidation value percentage (accounting again for certain special allocations). For example, the preamble deems the liquidation value percentage to be a "sound indicator of a partner's interest in a partnership." This is particularly important as it provides yet another data point in determining how the IRS might define a partner's interest in a partnership, as that term is not otherwise conclusively defined. However, taxpayers should remember that special allocations are ignored in the case of 80% or more controlled partnerships.

Third, taxpayers can no longer rely on Revenue Ruling 90-112 to limit the amount of US property included under section 951 to the amount of a CFC partner's adjusted basis in the partnership.

Fourth, it is clear that sections 951 and 956 are built around preventing undue deferral of income from cash being deployed. Therefore, it is curious that the final regulations are based on the cash being deployed, not the resulting income.

Fifth, the new rules clearly implicate third party lending if a loan would not have been made on its terms absent a principal purpose to avoid the application of section 956.

Finally, there are multiple effective dates rolled into the final regulations:

- Changes to 'developer' and 'active marketing' exceptions apply as of September 1, 2015.
- An obligation of a domestic partnership becomes an obligation of a US person under the regulations as of November 3, 2016.
- Revenue Ruling 90-112 is obsoleted as of November 3, 2016.
- Property is attributed to partners under Treas. Reg. §1.956-4(b) when a CFC's taxable year ends on or after November 3, 2016 with regard to property acquired on or after November 3, 2016. Former Treas. Reg. §1.956-3(a)(3) applies for taxable years of a CFC ending before November 3, 2016.

As noted above, the Final Regulations largely adopt the Temporary and Proposed regulations from September 2015, with few changes other than for purposes of clarity and administration. However, these changes could present a pitfall for the unwary, in particular the broadened anti-abuse rules. As is the case with all inbound and outbound planning involving pass-through structures, special care should be taken to evaluate the potential implications of even small changes when considering the taxpayer's overall tax and business objectives.

By Devan Patrick and Michael Farrell, Dallas

IRS Reconsiders the Treatment of M&A Termination Fees

Provisions in merger and acquisition agreements that obligate a terminating party to pay a termination fee to the other party are relatively commonplace. For some taxpayers the payment or receipt of such a fee can be material and its tax characterization as ordinary or capital significant. In the past, the IRS generally characterized merger and acquisition termination fees as ordinary; however in recent years, the IRS has revisited its analysis and its position. Two pieces of recently released internal IRS advice confirm the IRS's changed position regarding the proper tax characterization of termination fees paid in connection with mergers and acquisitions.

Historically, taxpayers have generally taken some comfort in the deductibility of merger termination fees based on case law and IRS guidance, e.g., PLR 200823012 and TAM 200438038. Such guidance determined that the applicable termination fees were in the nature of liquidated damages, the primary purpose of which was to provide the recipient with expectation damages or lost profits for benefits under the terminated acquisition agreement. Generally recovery of such damages or lost profits is treated as ordinary income.

CCA 201642035

On October 14, 2016, the IRS released CCA 201642035, a legal memorandum from the Office of Chief Counsel to an attorney in the Large Business and International Division advising that an acquiring corporation's receipt of a merger termination fee is a capital asset under Code Section 1234A and the amount of capital gain or loss recognized by such corporate depends on the extent to which the corporation's cost incurred in connection with the failed acquisition were properly capitalized under Treas. Reg. § 1.263(a)-5(a). The Chief Counsel's advice was sought regarding two situations. In both situations, a domestic corporate acquirer ("Acquirer") and publicly traded target corporation ("Target") enter into a merger agreement pursuant to which the parties agree to take steps that result in Acquirer's acquisition of Target's stock. The merger agreement requires Acquirer and Target to use best efforts to effectuate Acquirer's proposed stock acquisition through a merger of a newly formed, wholly owned subsidiary of Acquirer with and into Target, including by recommending the deal and its approval to their respective shareholders, subject to the Target shareholders' receipt of a better offer, and obtaining required governmental approvals. Target has a right to terminate the contract upon (i) entering into another agreement based on a superior offer, (ii) a rejection of Acquirer's offer by Target's shareholders, or (iii) a failure to obtain approval of Target's shareholders by a certain date. If the merger agreement is terminated due to one of the foregoing, Target must pay a termination fee of $1,000,000 to Acquirer. Target receives a superior offer from an unrelated company and enters into another agreement with the company making the superior offer. As a result, Target terminates the merger agreement and pays Acquirer the $1,000,000 termination fee.

In situation 1, Acquirer has incurred $200,000 of costs in the process of investigating and pursuing the transaction that Acquirer properly capitalized as costs of facilitating the proposed transaction under Treas. Reg. §1.263(a)-5(e). In situation 2, Acquirer incurs costs in the amount of $1,100,000 that Acquirer properly capitalized as costs of facilitating the proposed transaction under Treas. Reg. § 1.263(a)-5(e).

Chief Counsel advised that under section 1234A, any gain or loss attributable to the termination of a right or obligation with respect to property that would be a capital asset in the hands of the taxpayer is treated as a capital gain or loss. Therefore, in situation 1, Acquirer has a capital gain of $800,000 ($1,000,000 termination fee less Acquirer's $200,000 capitalized facilitative costs) from the sale of a capital asset under section 1234A because Acquirer's gain is attributable to the termination of Acquirer's right with respect to Target's stock, i.e., property that would have been a capital asset in Acquirer's hands.

In situation 2, Chief Counsel advised that Acquirer has a capital loss of $100,000 ($1,000,000 termination fee less Acquirer's $1,100,000 capitalized facilitative costs) from the sale of a capital asset under section 1234A because Acquirer's loss is attributable to the termination of Acquirer's right with respect to Target's stock, i.e., property that would have been a capital asset in Acquirer's hands.

In its analysis, Chief Counsel determined that under section 1221 Target's stock would be a capital asset in Acquirer's hands upon acquisition. The memorandum states that the merger agreement provides Acquirer with rights that relate to Acquirer's proposed acquisition of Target stock, imposes obligations on both parties with respect to Target's stock and provides Acquirer with rights with respect to Target's stock. The rights or obligations with respect to a target corporation's stock seems to be a crucial factor in the IRS's analysis. In explaining the advice, IRS associate chief counsel stated that a taxpayer could incur significant costs in an acquisition before a right or obligation with respect to stock arises, and in the absence of such a right or obligation, section 1234A would not apply.

Furthermore, the advice determined that the merger agreement termination fee payable to Acquirer is in the nature of liquidated damages rather than compensation for services. However, there is no analysis regarding the extent to which the purpose for the merger termination fee was to provide the recipient with expectation damages or lost profits.

FAA 20163701F

The CCA is consistent with FAA 20163701F, field attorney advice the IRS released on September 9, 2016, concluding that a taxpayer's payment of a merger termination fee is a capital loss under section 1234A. In its analysis the IRS, based on the purpose of section 1234A, characterizes the merger agreement as capital in nature because it provides Acquirer with rights and obligations with respect to stock, a capital asset. In FAA 20163701F, a corporate acquirer ("Acquirer") and a target corporation ("Target") entered into a merger agreement to set forth the steps for implementing a merger. The merger was conditioned upon Acquirer's board recommending the merger to its shareholders. Before the transaction could be consummated, the U.S. Treasury Department issued a notice that adversely affected the expected tax benefits of the proposed merger. Acquirer withdrew its recommendation for the merger. Under the merger agreement, Acquirer was required to pay a break fee to Target if Acquirer withdrew its recommendation for the merger. Acquirer paid a break fee to Target, which operated as the Target's sole and exclusive remedy for the terminated merger.

Though the IRS has unsuccessfully asserted similar positions in Tax Court, the recently published advice indicates that the IRS may continue to challenge the deductibility of merger termination fees under certain circumstances. Going forward, taxpayers will need to carefully consider the IRS's changed position in evaluating the tax treatment of merger and acquisition termination fees.

By Moe Worsley, San Francisco

Even if the Proposed 2704 Regulations Don't Get Trumped, it May Not be as Bad as we Thought

On December 1, 2016, the Treasury Department held a six-hour hearing on the much anticipated proposed Treasury Regulations under Code Section 2704 which are meant to provide clarification and impose further limitations on the use of valuation discounts for transfers of interests in family controlled entities for transfer tax purposes. (For further discussion, please see previously released Client Alert, *Impact on Business Valuations of Lapsed Rights and Restrictions on Liquidation of an Interest: Is This the End of Valuation Discounting As We Know It? Section 2704 Proposed Regulations Released,* distributed on August 18, 2016 and available under insights at www.bakermckenzie.com.) When the proposed regulations were released in August there was an immediate public outcry by practitioners with issues ranging from deemed put rights (valuations being required to deem all interest holders, regardless of the amount of their interest in the company, as having the ability to alone compel liquidation of the company) to proposed effective dates to the end to any applicable discounts when valuing the transfer of family owned businesses. This outcry led to thousands of comments being submitted to Treasury during the three months following their release. In response, several representatives from Treasury have spoken publically about what has been characterized as "misinformation" regarding the intent of the rules and what the proposed regulations require.

On several occasions, including the hearing, representatives from Treasury have made it clear that the proposed regulations do not have a deemed put right. Further, they have made it clear that the proposed regulations do not mean the end of all discounts when transferring family owned businesses. Instead, the proposed regulations are meant to eliminate several "estate freeze" techniques that Treasury believes are utilized in family estate planning which have the potential to undermine the application and intent of section 2704. In other words, Treasury's intent was to curb certain abuses by telling the appraiser what factors to ignore and not by asking appraisers to assume any fact that is not present. In practice, this should lead to status quo valuations except in the instances of the more aggressive valuations based on certain restrictions. These clarifications, if they are indeed reflected in any finalized regulations would be welcome.

During this time of public clarification, the American people elected Donald Trump to be the next President of the United States. President-elect Trump has signaled that he would support repeal of the estate tax and replace it with a tax on death of unrealized appreciation on capital assets as well as place a "moratorium" on all new federal regulations. This has led many to speculate that the proposed 2704 regulations will be put aside for the next four years. While our "Magic 8 Ball" continues to tell us to "Ask Again Later" regarding what the Trump presidency will or will not do regarding the proposed 2704 regulations, the above clarifications made by Treasury make clear that the initial concern regarding the over-reaching of the proposed regulations was unintended.

By Rodney W. Read, Houston

South Carolina Department of Revenue Appeals *Rent-A-Center* Decision

The South Carolina Department of Revenue ("Department") recently appealed the South Carolina Court of Appeal's decision in *Rent-A-Center West, Inc. v. South Carolina Dep't of Revenue*, Appellate Case No. 2012-208608 (Ct. of App. 2016) on November 30, 2016. The Court of Appeals held, on October 26, 2016, that the Department did not satisfy its burden to apply alternative apportionment to Rent-A-Center West, Inc. ("RAC West"). The Court of Appeal's decision is a significant victory for taxpayers in South Carolina as it reaffirms that the Department cannot rely on bald assertions to apply alternative apportionment.

Rent-A-Center Decision

The taxpayer, RAC West, is a subsidiary of Rent-A-Center Inc., a rent-to-own business. RAC West owns and operates retail stores in western states, in addition to owning and licensing Rent-A-Center's intellectual property (e.g., trademarks, trade names, etc.). RAC West licensed its intellectual property to an affiliate, Rent-A-Center East Inc. ("RAC East"), which owns and operates retail stores in eastern states, including South Carolina. RAC West had no other activities in South Carolina aside from licensing the intellectual property to RAC East for use in the state. Accordingly, on its South Carolina corporate income tax returns, RAC West reported a sales factor with a numerator that solely consisted of its South Carolina royalty receipts and with a denominator that consisted of its total royalty receipts and retail receipts.

The Department argued that South Carolina's standard apportionment formula did not properly represent RAC West's business activity in the state and proposed to exclude RAC West's retail sales from the denominator of its single-gross receipts factor apportionment formula, thereby increasing its South Carolina apportionment percentage. RAC West did not have any retail sales in the numerator of its South Carolina apportionment formula because it did not operate any retail stores in South Carolina. The Department's expert witness stated that, because RAC West did not have any retail sales in its South Carolina numerator, the standard formula was "putting apples in the numerator and apples and oranges in the denominator." He further testified that the Department's method was reasonable and that excluding RAC West's retail sales was essential "to come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina."

RAC West countered the Department's argument by demonstrating that "there is a unitary relationship between the business activities of the retail stores in the western states and the licensing of intellectual property in other states." RAC West argued that separating the receipts from the two activities would result in an inaccurate measure of RAC West's activities in South Carolina because of the inextricable link and synergy between the value of the intellectual property and the profitability of RAC West's retail business. Further, RAC West's expert explained, "the standard apportionment worked the way it was supposed to in this case."

The court held that the Department did not satisfy its burden to prove by a preponderance of the evidence that South Carolina's statutory apportionment formula did not fairly represent RAC West's business activities in the state. The court stated that the Department presented the same level of evidence as it did in *CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue*, where the South Carolina Supreme Court held that the Department failed to meet its burden of proof. (For further discussion, please see prior *Tax News and Developments* article, *Finding Fair Apportionment in South Carolina is a Burden* (Vol. 15, Issue 1, February 2015) and available under insights at www.bakermckenzie.com). The court further noted that the auditor did not point to any specific evidence in making its argument that the standard apportionment formula did not fairly represent RAC West's activity in the state.

"East-West" Structures and South Carolina's Increasingly Aggressive Position

Rent-A-Center employed what many state tax professionals would refer to as an "East-West" structure. The name comes from the fact that companies in the "East" tend to have more states that adopt separate reporting (e.g., New Jersey, Pennsylvania, etc.), while companies in the "West" tend to have more states that adopt combined reporting (e.g., California, Oregon, etc.). Accordingly, companies that set up "East-West" structures may be able to generate a deduction for intercompany payments in a separate ("East") reporting state, while the corresponding item of income may be offset or eliminated in the combined ("West") reporting state.

Here, the typical East-West tax benefits did not come into play because RAC West was already filing in South Carolina. If RAC West was not filing in South Carolina, RAC East would pay a royalty to RAC West and receive a deduction in South Carolina, but RAC West would not be required to report the royalty income in South Carolina as it would be a non-filer. Despite the fact that South Carolina was already subjecting RAC West's income to tax, it nonetheless attacked the transaction through an alternative apportionment argument arguing that RAC West should be apportioning more income into the state. However, as RAC West's experts clearly articulated, and the Court of Appeals ultimately determined, RAC West had no retail sales in the South Carolina numerator, and the plain language of the statute acted as intended by the legislature (i.e., the apportionment formula already took into account the Department's concern that RAC West's income would properly be apportioned to the state).

South Carolina's alternative apportionment argument is aggressive because most states that challenge East-West structures do so in an effort to bring the "West" entity into the state. For example, states frequently attack East-West structures, or related party transactions that yield a similar result, through an attempt to bring the income into the state (noting that many states also try to disregard the out-of-state entity's apportionment altogether), by: disguising transfer pricing adjustments (e.g., Massachusetts – *Kimberly-Clark Corp. v. Comm'r*, 981 N.E. 2d 208 (Mass. App. Ct. 2013), employing economic nexus (e.g., South Carolina - *Geoffrey v. S.C. Tax Comm'n,* 437 S.E.2d 13 (S.C. 1993)), or arguing a lack of economic substance (e.g., Maryland – *Gore Enterprise Holdings, Inc.,* Dkt. No. 07-C-10-000435*/ Future Value, Inc.,* Dkt. No. 07-C-10-000434 (Md. Ct. App. 2014), *ConAgra Brands Inc. v. Comptroller,* 09-IN-OO-0150 (Md. Tax Ct., Feb. 24, 2015), *Staples, Inc. v. Comptroller,* No. 09-IN-OO-0148 (Md. Tax Ct., May 28, 2015), etc.), among other tactics.

Here, RAC West was already filing in the state. Although not directly apparent in the case, RAC West may have been filing in South Carolina as a result of the *Geoffrey* economic nexus decision (holding that an out-of-state intangible holding company had nexus in South Carolina as a result of licensing its intangible property to an in-state related party), noting that the *Rent-A-Center* decision twice mentions that the Department's expert sought to "come up with a tax burden that fairly represented the economic nexus of the entity with South Carolina" and also states that the "royalty payments for the use of the intellectual property by South Carolina stores are RAC West's only activity in the state." Therefore, it appears that South Carolina may be taking an already aggressive position (i.e., economic nexus, which has not yet been heard by the U.S. Supreme Court) and escalating it to the next level (i.e., now attacking the statutory apportionment formula for an entity that would feasibly not have nexus in many other jurisdictions). Fortunately, the Court of Appeals properly determined that South Carolina did not meet its burden of proof for alternative apportionment.

As state revenue departments around the country are increasingly seeking to rely on alternative apportionment when making audit adjustments, this case highlights the heavy burden that state revenue departments must meet when asserting alternative apportionment. Taxpayers in South Carolina (as well as in other states with similar alternative apportionment authority) should vigorously object to unsupported assertions by state revenue departments that the statutory formula does not fairly represent the taxpayer's business activity in the state, pointing to this case, among others, for support. Based upon the Department's decision to appeal for a rehearing, it is clear that the Department is looking to aggressively pursue this issue. If the Department is unsuccessful in its rehearing, it could then petition to the South Carolina Supreme Court.

By David Pope, New York

Mississippi Supreme Court Finds Differing Treatment of Dividends Unconstitutional

After more than 16 years and two separate lawsuits, AT&T Corporation ("AT&T") finally succeeded in having Mississippi's differing treatment of certain dividends ruled unconstitutional. Specifically, the Mississippi Supreme Court upheld the Mississippi Chancery Court's decision in *Mississippi Dep't of Rev. v. AT&T Corp.*, Dkt. No. 2015-CA-00600-SCT (Miss. S. Ct. 10/27/2016), holding that the Mississippi dividend exclusion statute was unconstitutional under the dormant aspect of the Commerce Clause of the U.S. Constitution. The Court held that it was internally inconsistent and, as a result, not fairly apportioned, because it placed a greater tax burden on taxpayers engaged in interstate commerce than on taxpayers engaged in intrastate commerce.

This was not AT&T's first attempt at challenging the constitutionality of Mississippi's dividend exclusion statute. AT&T filed its first lawsuit in 2000, relating to tax years 1993-1996. And while the Chancery Court agreed with AT&T that the dividend exclusion statute was unconstitutional, the Mississippi Supreme Court overturned the ruling on procedural grounds because AT&T had failed to satisfy the state's bond requirement when it petitioned the Chancery Court. AT&T filed its second lawsuit on the constitutionality of Mississippi's dividend exclusion statute in 2004, relating to tax years 1997-1999.

Mississippi's Dividend Exclusion Statute Violated the Commerce Clause

Under the Mississippi dividend exclusion statute (Miss. Code Section 27-7-15(4)(i)), Mississippi taxpayers were allowed to exclude from their Mississippi tax base dividends that had been subject to the Mississippi tax, but not dividends that had not been subject to the Mississippi tax, e.g., dividends received from subsidiaries that did not have nexus in Mississippi. Armed with this provision, the Mississippi Department of Revenue ("Department") assessed AT&T $11.75 million in additional income tax, interest, and penalties for tax years 1997-1999 based on its income from subsidiaries that did not have Mississippi nexus.

AT&T protested this assessment, arguing that the differing treatment of dividends under Section 27-7-15(4)(i) established a discriminatory method of taxation in violation of the dormant aspect of the Commerce Clause of the U.S. Constitution. While the Commerce Clause is framed as a positive grant of power to Congress, it has been consistently held that there is a negative component, colloquially known as the dormant Commerce Clause, which, generally speaking, has been read to prohibit regulatory measures that benefit in-state economic interests by unequally burdening out-of-state companies that are similarly-situated. AT&T contended that Mississippi's treatment of dividends received from out-of-state subsidiaries (i.e., subsidiaries that were not subject to Mississippi income tax on their income) was unequal to the treatment afforded dividends received from in-state subsidiaries because only the latter were excluded from a taxpayer's Mississippi tax base. The Mississippi administrative tribunals disagreed with AT&T, but the Chancery Court of the First Judicial District of Hinds County sided with AT&T on grounds that Section 27-7-15(4)(i) was facially discriminatory. The Department appealed the case to the Mississippi Supreme Court.

Relying on a string of federal and state court cases as precedent, the Mississippi Supreme Court applied the four-part test from *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) to determine whether the dividend exclusion statute violated the dormant aspect of the Commerce Clause. The four-part test requires that: (1) the tax be imposed on an activity with a substantial nexus with the taxing state; (2) the tax be fairly apportioned; (3) the tax not discriminate against interstate commerce; and (4) the tax be fairly related to the services provided by the taxing state. The dispositive factor for the Mississippi Supreme Court was the second factor.

The second factor from *Complete Auto* has been read to require internal consistency, among other things, in order for a tax to be constitutional. In broad terms, a taxing statute is internally consistent when the statute would not impose a tax burden on interstate commerce that is different from the tax burden imposed on intrastate commerce, assuming the statute under review were enacted in each state. Quoting *Okla. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175 (1995), the Mississippi Supreme Court noted, "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." AT&T argued that the Mississippi dividend exclusion statute was not internally consistent because, if an identical statute was enacted in every state, dividends received by a parent company from a subsidiary that does not have nexus with the parent company's state would be taxed twice; whereas dividends received by a parent company from an in-state

subsidiary would be taxed only once. The Mississippi Supreme Court agreed, finding that the dividend exclusion statute was internally inconsistent and in violation of the fair apportionment requirement of *Complete Auto*, and therefore unconstitutional.

Commentary

The Mississippi Supreme Court's decision in this case is interesting because, rather than following the lower court's discrimination analysis under the third prong of *Complete Auto*, it analyzed the case under the fair apportionment analysis from the second prong of *Complete Auto*. In doing so, the Mississippi Supreme Court largely adopted the reasoning from the U.S. Supreme Court's recent holding in *Maryland v. Wynne*, 135 S. Ct. 1787 (2015), where the Court held that Maryland's taxing scheme violated the Commerce Clause because it did not allow Maryland residents to take a Maryland credit for local income taxes paid to other states. But rather than theorizing about the discriminatory nature of the state's taxing scheme, the Court in *Wynne* looked at the numbers in finding malapportionment. Similarly, the Mississippi Supreme Court looked at the economic effect of the dividend exclusion and found that it resulted in double taxation for AT&T and similarly-situated taxpayers.

As a result of this decision, Mississippi taxpayers that were either denied, or did not claim, the dividend exclusion for dividends received from affiliates that did not have nexus in Mississippi should consider filing refund claims for open years. Mississippi taxpayers should also consider whether they can claim the dividend exclusion on prospective returns.

By Trevor R. Mauck, New York

Canada Revenue Agency Insights into LLPs, LLLPs, and BEPS Action Item 13

At the Canadian Tax Foundation's ("CTF") annual roundtable with the Canada Revenue Agency ("CRA") in November, the CRA answered questions about US LLPs, LLLPs, and BEPS Action Item 13 that will be of interest to taxpayers with connections to Canada.

Treatment of Delaware and Florida LLPs and LLLPs in Canada

After a lengthy examination, the CRA has concluded that it will treat Delaware and Florida LLPs and LLLPs as corporations for Canadian tax purposes, seeing little difference between US LLCs and such LLPs and LLLPs. However, the CRA will also provide relief for taxpayers who might be taken by surprise by this administrative position. In order to have LLPs or LLLPs treated as partnerships rather than as corporations, the following requirements must be met (as set out in CRA interpretation 2016-0634951C6):

i) the entity must have been formed and must have begun to carry on business before July 2016;

ii) it must be clear from the surrounding facts and circumstances that the members:

- are carrying on business in common with a view to profit; and
- intended to establish an entity that would be treated for Canadian income tax purposes as a partnership and not a corporation

iii) neither the entity itself nor any member of the entity has ever taken the position that the entity is anything other than a partnership for Canadian income tax purposes; and

iv) the entity converts, before 2018, to a form of entity that is generally recognized as a partnership for Canadian income tax purposes.

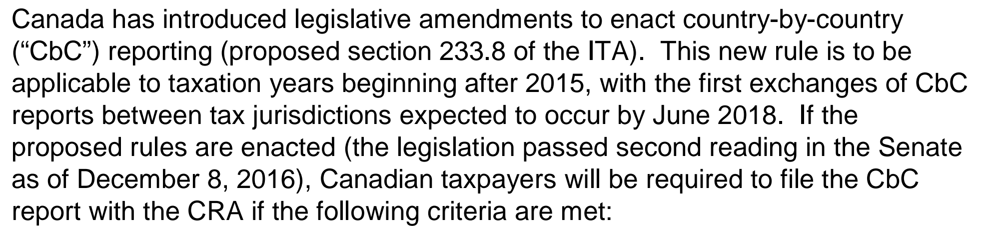
The CRA also recognized that taxpayers do not always have the ability to convert an LLP or LLLP into a more traditional partnership (for business or other practical reasons). As such, the CRA advised that taxpayers who partly meet the criteria set out above will face a "facts and circumstances" test to determine their appropriate Canadian tax treatment. Among other things, this test will look to whether there are any elements of tax avoidance in the desire to convert from a deemed corporation to a partnership structure. Moreover, taxpayers coming forward to the CRA about their particular facts and issues may receive relief for prior years (although they will still likely be treated as corporations prospectively). Finally, the CRA advised that it is still studying questions relating to the Canadian tax treatment of LLPs and LLLPs, and it therefore welcomes further comments from taxpayers and interested parties.

Stepping back, if taxpayers intended to have their LLPs and LLLPs treated as partnerships for Canadian tax purposes, they should seriously consider conversion under the CRA's administrative policy or another form of reorganization. Otherwise, they may be setting themselves up for a Canadian tax dispute in the future.

BEPS Action Item 13

BEPS Action Item 13 recommends a three-tiered approach to transfer pricing documentation for multinational entities - country-by-country reporting, a Master File, and a Local File.

While Canada has expressed support for the BEPS project and contributed significantly to the project, it has also noted that it did not expect to implement BEPS Action Item 13 in its entirety, given that the transfer pricing documentation requirements under the Canadian *Income Tax Act* ("ITA") already require extensive disclosures and address the items identified in the BEPS action plan. The current Canadian documentation requirements for multinational entities stem from the ITA's section 247. Under section 247, taxpayers are required to adhere to the arm's length principle and penalties may apply should the CRA make transfer pricing adjustments that exceed the penalty threshold. To avoid these transfer pricing penalties, taxpayers need to be able to demonstrate that they made reasonable efforts to determine and use arm's length transfer prices. This includes preparing contemporaneous transfer pricing documentation by the tax return due date and providing it to the CRA within three months of a CRA request for it.



Baker McKenzie
North America Tax

Chicago
+1 312 861 8000

Dallas
+1 214 978 3000

Houston
+1 713 427 5000

Miami
+1 305 789 8900

New York
+1 212 626 4100

Palo Alto
+1 650 856 2400

San Francisco
+1 415 576 3000

Toronto
+1 416 863 1221

Washington, DC
+1 202 452 7000

Canada has introduced legislative amendments to enact country-by-country ("CbC") reporting (proposed section 233.8 of the ITA). This new rule is to be applicable to taxation years beginning after 2015, with the first exchanges of CbC reports between tax jurisdictions expected to occur by June 2018. If the proposed rules are enacted (the legislation passed second reading in the Senate as of December 8, 2016), Canadian taxpayers will be required to file the CbC report with the CRA if the following criteria are met:

1) The taxpayer is the ultimate parent of a multinational enterprise ("MNE"), which members are resident in different jurisdictions (collectively, "MNE Group"); or

2) Any of these situations exists:
    a. the ultimate parent (or surrogate parent) of the MNE Group is not obligated to file a CbC report in its jurisdiction of residence;
    b. the parent's jurisdiction does not have a qualifying competent authority agreement in effect with Canada when it is required to file a CbC report; or
    c. the parent's jurisdiction has a "systemic failure" in respect of such reporting and the CRA notifies the constituent entity of this systemic failure.

There are other caveats or exceptions to keep in mind. For example, the ultimate (or surrogate) parent of an MNE Group may file a CbC report instead of the Canadian constituent entity if the parent notifies its jurisdiction's tax authorities that it is filing as an ultimate or surrogate parent. As well, the United States has entered into a qualifying competent authority agreement with Canada and is expected to finalize its reporting process soon; this would make a US entity a valid surrogate parent once the reporting process is finalized.

Notably, the proposed CbC rule will have no direct relation to or impact on the existing transfer pricing documentation rule or the obligation for Canadian taxpayers to make reasonable efforts to determine and use arm's length transfer prices for purposes of the ITA. However, if the new rules are enacted as proposed (which is expected), CbC reporting will add another dimension (and burden) to MNEs with significant Canadian operations.

By Christopher (Chris) Raybould, Mark Tonkovich and Valérie Duchesneau, Toronto

Baker McKenzie Tax Teams with Tax Executives Institute in Toronto for our 39th Annual North America Tax Conference -- and You're Invited!

On February 9th, Baker McKenzie and Tax Executives Institute ("TEI") in Toronto will join forces to present a full-day seminar at the Fairmont Royal York Hotel to discuss many of the recent legislative changes and important tax issues impacting not only Canadian companies, but US and multinational companies doing business in Canada and elsewhere around the globe. The complimentary program is open to clients and friends of our Firm and to all TEI members who will be in or near Toronto.

Baker & McKenzie
300 East Randolph Drive
Chicago, Illinois 60601, USA
Tel: +1 312 861 8000
Fax: +1 312 861 2899

We are especially pleased to announce that The Honourable Eugene P. Rossiter, Chief Justice of the Tax Court of Canada, will be our keynote luncheon speaker and provide his unique insight into many of the most important tax issues of the day.

This year's program, ***Tomorrow's Tax Landscape: Canada and Beyond*** is being presented in conjunction with Baker McKenzie's 39th Annual North America Tax Conference which brings together our US and Canadian tax practitioners as well many of our tax colleagues around the globe, while celebrating the 60th anniversary of the TEI Toronto chapter.

Among the topics on this year's agenda are recent tax updates in the BEPS implementation, APA and MAP resolution of tax controversies, trends in cross-border M&A, and the extended reach of the recently-enacted Code Section 385 regulations. Participants will also be able to customize their agenda by selecting among a variety of morning and afternoon breakout topics that will explore various Canadian, US, and cross-border topics of particular interest to them and their company. The complete agenda and registration details for the February 9th seminar can be accessed here *North America Tax Conference* or online at www.bakermckenzie.com/tax.

As an added treat this year, in recognition of our group's visit to Canada and to celebrate TEI Toronto's 60th year anniversary, guests who participate in the full-day program will be able to join us for a private reception and dinner event at the nearby Hockey Hall of Fame, where we will have an opportunity to network with old and new friends, and tip our hat to the centennial anniversary of the NHL and the Toronto Maple Leafs organization!

We hope you can join us in Toronto! If you have any questions about the program, or if you would like to arrange a complimentary meeting with any of our tax practitioners on Wednesday in advance of the Thursday, February 9th seminar, please contact us by email to taxnews@bakermckenzie.com or reach out by phone to Marie Caylor in Chicago at +1-312-861-8029.

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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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