# Newsletter

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## The New Administration's Activities Related to Tax Administration

With all the activity coming from 1600 Pennsylvania Avenue in the past few weeks, tax practitioners may have overlooked some important developments related to Administration personnel and the administrative state.

### Staffing Treasury

On February 13, 2017, the Senate confirmed Steven Mnuchin as Secretary of the Treasury on a 53-to-47 vote. Senator Joe Manchin (D-WV) crossed party lines to confirm Mnuchin. Announcements on some sub-Cabinet officials at the Treasury Department (although not necessarily the Assistant Secretary for Tax Policy and Chief Counsel of the IRS) are expected to be made in the coming days.

### White House Activity

On January 20, Reince Priebus, White House Chief of Staff, issued a memorandum to the heads of executive departments and agencies, instructing them to (1) refrain from sending regulations to be published in the Federal Register until a department or agency head appointed by President Trump reviews and approves the regulation, (2) withdraw any regulations that have been sent to the Federal Register but not yet published, and (3) postpone the effective date for sixty days for any regulations that have been published in the Federal Register but have not yet become effective to permit those regulations to be reviewed for questions of law, fact, and policy. (*See* https://www.whitehouse.gov/the-press-office/2017/01/20/memorandum-heads-executive-departments-and-agencies.) The memorandum provides an exception for regulations that are subject to statutory or judicial deadlines, and allows agencies to request an exemption from the Director of the Office of Management and Budget (OMB) for specific regulations on a case-by-case basis. The memorandum defines "regulation" as any "regulatory action" as defined in section 3(e) of Executive Order 12866.

After the memorandum was released, Treasury withdrew the proposed regulations implementing the partnership provisions in the Bipartisan Budget Act of 2015 from the Federal Register, as noted in a subsequent article in this issue, see *IRS Discloses Proposed Partnership Audit Regulations*. No other tax regulations appear to have been affected by the memorandum.

On January 30, President Trump signed an Executive Order titled, "Reducing Regulation and Controlling Regulatory Costs." (*See* https://www.whitehouse.gov/the-press-office/2017/01/30/presidential-executive-order-reducing-regulation-and-controlling.) Generally, the Executive Order provides that (1) for every new regulation issued, at least two prior regulations should be identified for elimination and (2) for fiscal year 2017 (which ends on September 30, 2017), the total incremental cost for all regulations that are

## Upcoming Tax Events

Financial Services Industry Tax Briefing Series

New York, New York
- February 23, 2017
- May 2, 2017

New Strategies for International Trade & Supply Chains under the Trump Administration: Options; Timetables; Preparations

Durham, North Carolina
- March 2, 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

14th Annual Global Tax Planning and Transactions Workshop

New York, New York
- May 9, 2017

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

finalized shall not be greater than zero (unless otherwise required by law or consistent with written advice provided by the OMB Director). The Executive Order defines "regulation" broadly to include "an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or to describe the procedure or practice requirements of an agency."

On February 2, the Acting Administrator of the Office of Information and Regulatory Affairs (OIRA) issued interim guidance interpreting the Executive Order. (*See* https://www.whitehouse.gov/the-press-office/2017/02/02/interim-guidance-implementing-section-2-executive-order-january-30-2017.) The Frequently Asked Questions section of the interim guidance provides that Trump's executive order only applies to "significant regulatory actions" as that term is defined in section 3(f) of Executive Order 12866. While Treasury and IRS routinely take the position that IRS regulations are not "significant regulatory actions" as defined in E.O. 12866, it is unclear whether and how the Executive Order will be applied to tax regulations.

## Tax Reform Update and Steps Companies Should Take Now to Prepare For Tax Reform

President Trump announced that he will release a comprehensive tax reform plan by the end of the month. President Trump is scheduled to address Congress in a joint session, and it is possible that he could describe his plan at that time. An open question is whether the White House will propose an independent plan or sign on to the House Republican Blueprint for Tax Reform.

In its first few weeks, the Trump administration has demonstrated its intention to move quickly to implement its agenda and companies that are interested in engaging in tax reform discussions must also move quickly. Companies should—if they haven't already—closely review the House Republican Blueprint for Tax Reform to analyze how they would be affected by its proposals and model its economic effects. (For further discussion of the House Republican Blueprint, please see prior *Tax News and Developments* article, *Understanding the 2016 Election Results and Their Impacts on Tax Reform*, (Vol. XVI, Issue 6, December 2016) available under Insight at www.bakermckenzie.com/tax.) In addition, companies should reach out to the industry groups of which they are members to determine what efforts the industry group is undertaking with respect to tax reform. Finally, companies should develop a strategy for engaging with members of the Ways & Means Committee, the Senate Finance Committee, and administration personnel to emphasize their goals and raise any concerns during the tax reform process.

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

# US Treasury Releases Final & Temporary Section 987 Regulations

On December 7, 2016, the United States Treasury and the IRS released over 250 pages of regulations under Subpart J, covering foreign currency issues. Although the Final and Temporary regulations address a number of issues under subpart J, they are primarily focused on the implementation of Code Section 987.

The effective date for the vast majority of the Section 987 Regulations is for the first taxable year beginning after December 6, 2017. Thus, for most taxpayers, the Section 987 Regulations will become effective for tax years beginning on January 1, 2018. However, taxpayers can elect to apply the Section 987 Regulations to taxable years beginning after December 7, 2016. Practically, however, it is unlikely that a taxpayer who is not already following the 2006 Proposed Regulations will be able to elect to apply the Section 987 Regulations early because of the considerable compliance hurdles and information required to apply these rules.

Every individual or "C" corporation taxpayer that operates in a different country through a branch, disregarded entity, or maintains a separate set of books and records for a line of business in a currency different than its owner is affected by the Section 987 Regulations. However, the taxpayers that should care most about the Section 987 Regulations are those taxpayers who have significant numbers of material foreign disregarded entities. Some of these taxpayers may be able to plan their way out of section 987 by choosing to "uncheck" or incorporate their existing section 987 qualified business units ("QBUs").

The Section 987 Regulations represent a significant departure from existing practice for the vast majority of US-based multinationals. Although the regulations do provide a transition period, taxpayers should start considering any systems changes they will need to make now. This is because the Section 987 Regulations require the taxpayer to maintain information that is not required for US Generally Accepted Accounting Principles ("GAAP") purposes, or for any other purpose. Most taxpayers are following GAAP and not making significant adjustments for tax. This will have to change. Compliance with the Section 987 Regulations will require "systems" changes either to their accounting software or tax software, as it likely will not be possible for taxpayers to perform all of the computations required in an Excel spreadsheet outside of their accounting software, especially with respect to inventory. Thus, unless taxpayers can plan their way out of section 987, compliance with these regulations will likely represent a very significant exercise for many taxpayers.

Treasury incorporated two helpful elections into these new regulations to try and ameliorate some of the difficulties of these new regulations. The first is an election to "deem" all section 987 QBUs to terminate every year and use an average exchange rate to translate certain items. However, taxpayers will need to be prepared to make that election the first year the regulations apply (most likely calendar years beginning January 1, 2018) or else their ability to make the election later will be limited. There are a number of other elections that taxpayers have to consider for the first year in which these elections apply.

In addition, taxpayers would be well advised to take notice that section 987 gain or loss is not just something that impacts the E&P of a CFC. Treasury is taking the position that section 987 gain is subpart F income. Although we believe taxpayers have strong arguments that the Treasury lacks the authority for that position, it is the position Treasury took in the Final Section 987 Regulations.

For a more detailed analysis regarding the mechanics of the Section 987 Regulations and planning pointers, please see the recently updated North America Tax Client Alert, *US Treasury Releases Final & Temporary Section 987 Regulations*, previously distributed on January 9, 2017 and available under Insight at www.bakermckenzie.com/tax.

***By Joshua S. Richardson, Chicago***

## Notice 2016-73: The Final Chapter?

On December 2, 2016, Treasury and the IRS issued Notice 2016-73 (the "Notice"), the sixth and most recent guidance in a ten-year cat-and-mouse game to prevent taxpayers from using triangular B reorganizations to facilitate repatriation of cash.

The original version of the transaction, described in the press as the "Killer B," involved a foreign subsidiary ("FS") acquiring its US parent ("USP") stock in exchange for cash or a note, then exchanging USP stock to acquire a foreign target (FT) in a triangular B reorganization. Although USP stock constituted "US property" under Code Section 956, no section 956 amount would arise as long as FS disposed of the stock before its quarter end. USP could have tax-free access to foreign cash up to the value of FT.

After several pronouncements (Notice 2006-85, Notice 2007-48, and Temp. Treas. Reg. § 1.367(b)-14T), Treasury promulgated Treas. Reg. § 1.367(b)-10 (the "Regulations") in 2011. The Regulations applied recast rules to a triangular B reorganization where (i) parent or subsidiary was foreign and (ii) subsidiary acquired parent stock in exchange for property. If the Regulations applied, immediately before the reorganization, subsidiary was deemed to distribute to parent the property used to acquire parent stock ("deemed distribution"), and parent was deemed to contribute that same property back to subsidiary ("deemed contribution"). However, under a coordinating rule (the "367(a) Priority Rule"), if gain recognized by target shareholders under Code Section 367(a)(1) (the "367(a) Amount") was less than or equal to the aggregate Code Section 301(c)(1) and 301(c)(3) amounts that would have resulted were the Regulations to apply (the "367(b) Amount"), then the Regulations would not apply. In other words, subsidiary would not be deemed to make a distribution to parent, and the sale of parent stock for cash or a note should presumably be tax free under Code Section 1032.

One of the recent triangular B reorganization variations arose, ironically, from Treasury and the IRS's attempt to shut down a perceived abuse with the issuance of Notice 2014-32. This IRS notice largely followed the 367(a) Priority Rule in the Regulations, but limited the 367(b) Amount to amounts that would be subject to US tax, either directly under section 301 or indirectly from a subpart F inclusion. This gave rise to a variation of the triangular B reorganization (the "Lower Tier B") which involved two transactions. First, FS acquired stock of a foreign parent ("FP"), rather than USP, in exchange for cash or a note, and FS exchanged the FP stock as consideration to acquire FT in a triangular B reorganization. Pursuant to the Code Section 954(c)(6) look-through rule, the deemed distribution would not result in section 301(c)(1) dividend income to the extent of FS E&P. The 367(b) Amount would be zero if both (i) the sum of FS E&P and FP basis in FS stock was greater than or equal to the value of FT stock, and (ii) the deemed distribution was not a US source dividend subject to withholding tax under Code Section 881. In that case, the 367(a) Priority Rule would turn off the Regulations, and section 1032 would instead govern FS's purchase of FP stock. Second, in a subsequent transaction, FP could engage in an inbound reorganization or Code Section 332 liquidation where FP transferred its assets to a US affiliate (an "inbound transaction"), whereby the cash or note held by FP would be owned by a member of the US consolidated group. The inbound transaction would result in US tax only to the extent of FP's "All E&P Amount" under Treas. Reg. § 1.367(b)-2(d). Importantly, the All E&P Amount would not include the value of the cash or note held by FP, nor the undistributed E&P of FP's foreign subsidiaries.

## The Notice

The Notice directly affects triangular B reorganizations with foreign targets in three ways: (i) the 367(a) Priority Rule is limited to domestic targets; (ii) target shareholders are required to recognize gain with respect to target stock as a Code Section 1248 dividend and as further described below; and (iii) nonqualified preferred stock ("NQPS") is included in the definition of "property" for purposes of the Regulations. Additionally, and most significantly, the Notice goes beyond the scope of triangular B reorganizations by changing the rules on inbound transactions, regardless of whether the inbound transaction was related to a triangular B reorganization.

### Revised 367(a) Priority Rule

The Notice limits the 367(a) Priority Rule to domestic targets. In a triangular B reorganization with a foreign target, the 367(a) Priority rule will no longer apply to turn off the Regulations. Accordingly, in a Lower Tier B, FS will be deemed to distribute the cash or note used to acquire P stock in a section 301 distribution.

### 1248 Dividend and Recognition of Remaining Gain

In an exchange under Code Section 354 or 356 in connection with a triangular B reorganization subject to the Regulations, Treas. Reg. § 1.367(b)-4 and 4T (as amended by the Notice) applies to the exchange, rather than section 367(a)(1). Specifically, in a Lower Tier B, the Notice would require FT shareholders to include in income as a deemed divided the amount determined under 1.367(b)-2(c) (the "1248 Amount") attributable to FT shareholders' FT stock exchanged, and, after increasing the basis in FT shares by the 1248 dividend, recognize any remaining gain realized on the exchange. This effectively turns off the nonrecognition treatment to FT shareholders.

Therefore, in a Lower Tier B, not only is FS treated as making a section 301 distribution of the cash or note paid to FP, but FT shareholders are required to recognize a 1248 dividend and any remaining gain on FT stock.

## NQPS

Another variant (the "Preferred B") involves FP issuing NQPS, rather than common stock, to USP in exchange for USP stock. Some taxpayers took the position that the Regulations did not apply because NQPS are not considered property under subchapter C. Thus, USP would take a fair market value basis in purchased FP NQPS under section 1032. FP could later redeem the NQPS owned by USP. USP would have little or no US tax due to FP's low E&P and USP's stepped-up basis in FP NQPS. The Notice shuts down the Preferred B by including NQPS as "property" for purposes of the Regulations.

## Inbound Transactions

As mentioned above, prior to the Notice, the second step in the Lower Tier B typically involved an inbound transaction of FP, and such transaction would only result in US tax to the extent of FP's All E&P Amount. The Notice introduces new terminology and mechanical rules to potentially increase amounts included as a dividend in an inbound transaction, regardless of whether the inbound transaction was related to a triangular B reorganization. Specifically, if the foreign acquired corporation (the foreign corporation that transfers its assets to a US corporation in the inbound transaction) has "excess asset basis," then the exchanging US shareholder must include in income as a dividend not only the All E&P Amount but also the "specified earnings." Excess asset basis is defined as foreign acquired corporation's inside asset basis, less the aggregate of (i) outside stock basis in foreign acquired corporation, (i) foreign acquired corporation's E&P, and (iii) assumed liabilities of foreign acquired corporation.

The Notice provides a mechanical computation to determine specified earnings, which could include undistributed E&P of lower-tier CFCs. Specified earnings is defined as the lesser of (but not below zero): (i) E&P of foreign acquired corporation's lower tier CFCs attributable under section 1248(c)(2), (ii) excess asset basis multiplied by the specified percentage, and (iii) specified stock gain. The specified percentage is the amount of the exchanging shareholder's specified stock gain over the total specified stock gain. Specified stock gain is the amount of gain that would be realized by the exchanging shareholder if the exchanging shareholder had sold FP stock, reduced by the exchanging shareholder's All E&P Amount.

The Notice effectively limits repatriation benefits of triangular B reorganizations of foreign targets. Unfortunately, the many attempts to kill the "Killer B" and its variants have resulted in convoluted *ad hoc* revisions to the general application of section 367(a) and 367(b). Taxpayers who have already engaged in Lower-Tier Bs before December 2, 2016, but have not inbounded the foreign acquired corporation, and taxpayers considering any inbound transactions under any other circumstances, should pay close attention to the new rules under the Notice.

***By Erik J. Christenson, San Francisco and Michelle Ng, Palo Alto***

## Newly Issued Section 901(m) Regulations

Before the close of 2016, the IRS issued its first set of regulations governing Covered Asset Acquisitions ("CAAs"). These are transactions that generally result in an increase in the basis of an asset for US income tax purposes without a corresponding increase in basis for foreign income tax purposes. As will be explained, this new guidance implements Code Section 901(m), enacted in 2010 as part of anti-abuse legislation aimed at preventing taxpayers from artificially increasing their rate of foreign tax paid. The IRS issued new comprehensive guidance in the form of both proposed and temporary regulations. Although the proposed regulations have a prospective effective date, they may be applied retroactively at the taxpayer's option, and the drafters indicated that they intended the temporary and proposed regulations to be read in tandem. Thus, for simplicity, they will be referred to mutually as the "Regulations." In this article, we will provide a brief overview of the Regulations and discuss their impact on transactions involving the buying and selling of certain types of assets.

### What's the Issue?

CAAs often (but not always) afford taxpayers the opportunity to manipulate the rate of foreign tax paid. This is because CAAs are generally treated as asset acquisitions for US income tax purposes and instead as either stock acquisitions or disregarded transactions for foreign income tax purposes. Consequently, CAAs result in an acquired entity's assets being stepped up to fair market value for US purposes, even though no adjustment to basis is made under foreign law. This step up results in the earnings and profits of the target being lower than would otherwise be the case, whereas the foreign tax credit pool (determined under foreign law) remains the same. This results in a taxpayer's creditable foreign tax pool becoming "hyped" *vis-à-vis* the target's earnings pool.

With that in mind, the Regulations identify six categories of transactions that are considered CAAs, three of which are already codified by statute, while the remainder were introduced as additional categories:

> (1) a qualified stock purchase to which section 338(a) applies; (2) any transaction that is treated as an acquisition of assets for US income tax purposes and as the purchase of stock for foreign tax purposes; (3) any acquisition of an interest in a partnership that has an election in effect under section 754; (4) any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for US tax purposes and an acquisition of a "fiscally transparent entity" for foreign purposes; (5) any transactions (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution where the US tax basis consequences are determined under section 732(b) or (d) or which causes the basis of assets to be adjusted under section 734(b), but only if

the adjustment results in a basis increase in one or more assets distributed without a corresponding increase in the foreign basis of such assets; and (6) any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of US and foreign tax, provided the transaction results in an increase in the US basis without a corresponding increase in the foreign basis of one or more assets.

The first four categories contain the types of transactions that are expected to constitute CAAs, since they generally result in an increase in the basis of an asset for US purposes without a corresponding increase in basis for foreign tax purposes. Conversely, the final two categories depict transactions that would not typically be considered CAAs, but for the fact that they result in a basis increase for US income tax purposes without a corresponding basis increase for foreign tax purposes.

## Basic Mechanics

To reduce this potential for inflated foreign tax credits in situations involving CAAs, section 901(m)(1) operates to deny a foreign tax credit for the "Disqualified Portion" of any foreign income tax determined with respect to the income or gain attributed to Relevant Foreign Assets ("RFAs"). For this purpose, an RFA is any asset (including goodwill, going concern value, or other intangible) acquired in a CAA that is "relevant" in determining the appropriate amount of foreign income tax in the relevant jurisdiction. An asset is deemed relevant in determining the appropriate amount of foreign income tax if it generates income, deduction, gain or loss that is taken into account in determining the foreign tax base immediately following the CAA.

Once RFAs have been identified, the next step in computing the Disqualified Portion is to determine the "Basis Difference" with respect to each RFA. The Regulations define Basis Difference as the difference (positive or negative) between the US tax basis of a RFA immediately before a CAA and the US tax basis immediately after a CAA. According to the Regulations, a Basis Difference has to be computed for each type of foreign income with respect to which an RFA is relevant.

Once the taxpayer has determined which assets constitute RFAs and their corresponding Basis Differences, the taxpayer must then calculate the Disqualified Portion – *i.e.*, the portion of foreign income tax that is not taken into account for purposes of calculating the foreign income tax credit of a taxpayer. The Regulations provide that the Disqualified Portion is the lesser of (i) the tentative disqualified tax amount and (ii) the foreign income tax amount paid or accrued by, or consideration paid or accrued by, a taxpayer eligible to claim US foreign tax credits ("Eligible Taxpayer"). The "tentative disqualified amount" is determined by multiplying an Eligible Taxpayer's foreign income tax paid or accrued by a ratio. The numerator of the ratio is the aggregate Basis Difference for all RFAs allocable to that year, and the denominator of which is the Eligible Taxpayer's foreign income tax basis upon which the income tax is imposed.

Although the statutory scheme, on its face, appears to be quite simple, the actual mechanics are very complicated. That is where the Regulations provide helpful guidance. In particular, the regulations helpfully delineate what determinations taxpayers have to make under foreign law, and what determinations have to be made under US tax law.

A thorough explanation of the Regulations is beyond the scope of this article. Nevertheless, it is important for taxpayers to be aware of two important exceptions aimed at reducing the burden placed on taxpayers attempting to comply with section 901(m).

## Foreign Basis Election

To determine the Basis Difference with respect to each RFA, taxpayers must compare the US tax basis of an RFA immediately before and immediately after a CAA. However, if a foreign target is owned by a foreign taxpayer, the foreign target has likely never made such basis calculations before. Helpfully, the Regulations provide a useful “Foreign Basis Election.” Specifically, the Foreign Basis Election allows taxpayers to use an asset’s foreign basis immediately after the CAA in substitution for the US tax basis of the asset immediately prior to the CAA. As a result, the burden of reconstructing a foreign target’s US basis for each RFA immediately before the CAA is alleviated. Helpfully, an election may be filed separately for each CAA. Yet, all elections are irrevocable once filed and if an election is not timely filed, it is does not qualify for an extension under the relief provisions of Treas. Reg. §301.9100-1.

## *De Minimis* Exceptions

Moreover, taxpayers should appreciate the fact that the Regulations also contain a “*De Minimis* Exception.” Under this exception, certain Basis Differences are not taken into account for purposes of section 901(m). A Basis Difference with respect to a CAA is not taken into account for purposes of section 901(m) if either of the following two tests are met. First, if the aggregate Basis Difference for all RFAs with respect to a single CAA is less than the greater of: (i) $10 million or (ii) 10 percent of the total US basis of all RFAs immediately after the CAA. Second, if the RFA is part of a class of RFAs for which the absolute value of the Basis Difference for all RFAs in the class is less than the greater of: (i) $2 million or (ii) 10 percent of the total US basis of all RFAs in the class.

Although the *De Minimis* Exception is welcome, the utility of the exception is limited by the fact that the Regulations permit the IRS to aggregate CAAs occurring pursuant to the same overall plan. Thus, if a multinational acquires ten different entities in ten different jurisdictions, each individual CAA may qualify for the *De Minimis* Exception. Nevertheless, the exception will not apply if the IRS aggregates the CAAs together and applies the *de minimis* thresholds to the aggregate figures.

Large multinationals will not likely derive a significant benefit from the *De Minimis* Exception to the Regulations. This is because the CAA aggregation rule will likely exclude most acquisitions from the rule. Nevertheless, multinationals will want to seriously consider making the Foreign Basis Election when making Code Section 338(g) and Code Section 754 elections for foreign targets that have not previously been owned by US corporations.

***By Jordan Joseph Hughes, Chicago***

# Treasury and IRS Finalize Controversial Proposed Regs. Under Section 367, Retroactively Precluding Tax-Free Outbound Transfers of Foreign Goodwill and Going Concern Value

On December 15, 2016, Treasury and the IRS issued final Treasury Regulations under Code Sections 367(a) and 367(d) ("Final Regulations") which largely finalized the controversial proposed regulations issued fifteen months earlier ("2015 Proposed Regulations"), and withdrew portions of the temporary regulations dating back to 1986 ("Temporary Regulations"). In fact, the preamble to the Final Regulations primarily consisted of Treasury and the IRS' response to numerous critical comments received in response to the 2015 Proposed Regulations, in an effort to justify the retention of such proposed rules.

By finalizing the 2015 Proposed Regulations (with only certain modifications discussed below) the Final Regulations:

(1) Eliminate the favorable treatment afforded for foreign goodwill and going concern value in the Temporary Regulations under section 367(d), and narrow the scope of the active trade or business exception ("ATB exception") under section 367(a) to effectively exclude foreign goodwill and going concern value from falling within the ATB exception;

(2) Create an allowance for US transferors to apply section 367(d) to certain property that otherwise would be taxed under section 367(a), provided it is not eligible for the ATB exception;

(3) Generally remove the twenty-year limitation on useful life for section 367(d) purposes, thereby requiring inclusion of deemed royalty payments during the entire useful life of the transferred property, but in contrast to the 2015 Proposed Regulations, permit the US transferor to make an election in the year of transfer to instead include such payments for only a 20 year period beginning in the first tax year in which an inclusion is required;

(4) Eliminate the exception from section 367(a) for transfers of property denominated in the currency of the country in which the transferee foreign corporation is organized, and revise the foreign currency exclusion from the ATB exception to refer to nonfunctional currency and other property that gives rise to a Code Section 988 transaction of the taxpayer described in section 988(c)(1)(B), or that would give rise to such a section 988 transaction if it were acquired, accrued, or entered into directly by the taxpayer; and

(5) Revise the valuation rules under Treas. Reg. § 1.367(a)-1T to better coordinate the regulations under Sections 367 and 482 (including temporary regulations under Section 482 issued with the 2015 Proposed Regulations).

In addition to the above, what might be most notable is that the Final Regulations retain the retroactive effective date contained in the 2015 Proposed Regulations, and therefore apply to outbound transfers occurring on or after September 14, 2015.

In general, section 367(a) and the regulations thereunder preclude non-recognition treatment for certain transfers of property to foreign corporations by US transferor corporations, and instead subject such transfers to immediate tax on the gain in the transferred assets. The only major exception to this general rule applies to US transferors making outbound transfers of property if the receiving foreign corporation will use such property in active trade or business, the ATB exception.

In the case of certain intangibles set out in Code Section 936(h)(3)(B), section 367(d) provided taxpayers making a transfer in a Code Section 351 or Code Section 361 exchange an election to recognize an income stream over the useful of the life of the intangible, which has historically been limited to a maximum of 20 years. While it remains unresolved, even under the Final Regulations, whether foreign goodwill and going concern value are section 936(h)(3)(B) intangibles, the prior Temporary Regulations under section 367(d) provided that foreign goodwill and going concern value were not subject to section 367(d).

Previously, when applying these rules, taxpayers have been able to take the position that outbound transfers of foreign goodwill and going concern value have only been subject to section 367(a) and the regulations thereunder. Furthermore, taxpayers have been able to utilize and rely on the ATB Exception to receive non-recognition treatment on the transfer of such intangible assets.

In the preamble to the 2015 Proposed Regulations, Treasury and the IRS expressed concern that taxpayers were using these provisions and aggressive valuation methods to categorize an inappropriate portion of the value of property transferred in an outbound transaction as foreign goodwill and going concern value in order to minimize their tax exposure. The preamble to the 2015 Proposed Regulations also set out the concern that taxpayers were overbroad in their interpretation of foreign goodwill and going concern value in a section 367 context. While the temporary regulations defined foreign goodwill and going concern value by reference to businesses operations outside the US, the IRS and Treasury expressed a desire to exclude activities conducted primarily in the US on behalf of foreign customers from increasing the value of foreign goodwill and going concern value. The preamble to the Final Regulations explains the IRS and Treasury position that, while the legislative history of section 367 and the regulations thereunder show Congressional intent to allow foreign goodwill and going concern to be transferred without immediate gain recognition, the IRS and Treasury believe the taxpayer positions under the existing section 367(a) and section 367(d) provisions are inconsistent with the expectation that allowing for non-recognition in this context would not lead to tax abuse.

As outlined above, the Final Regulations modify the rules to effectively require that taxpayers recognize gain on the transfer of foreign goodwill and going concern value to foreign corporations. Despite numerous comments requesting guidance in response to the 2015 Proposed Regulations, the Final Regulations do not resolve whether foreign goodwill and going concern value is a section 936(h)(3)(B) intangible but instead require that taxpayers choose to apply either section 367(a) or Section 367(d) to any property that is being transferred in an outbound transaction and is not a section 936(h)(3)(B) intangible or property that is eligible for the ATB exception.

In the section 367(a) context, the Final Regulations essentially mirror the 2015 Proposed Regulations, which limited the applicability of the ATB Exception under section 367(a) to tangible property, working interests in oil and gas property and certain financial assets, in each case, other than (1) inventory or similar property, (2) installment obligations, accounts receivable or similar property, (3) 'nonfunctional currency,' and (4) certain leased tangible property. As a result, intangible assets, including foreign goodwill and going concern value will not be eligible for the ATB exception under the Final Regulations.

As noted above, in the section 367(d) context, the Final Regulations eliminate the section 367(d) exception for foreign goodwill and going concern value. However, where the 2015 Proposed Regulations removed the twenty-year limitation on useful life for section 367(d) purposes, thereby requiring inclusion of the deemed royalty payments during the entire useful life of the transferred property, the Final Regulations permits the US transferor to make an election in the year of transfer to instead include such payments for only a 20 year period beginning in the first tax year in which an inclusion is required.

Finally, as noted above, the Final Regulations retain the retroactive effective date contained in the 2015 Proposed Regulations, and therefore apply to outbound transfers occurring on or after September 14, 2015.

On a closing note, taking into account the legislative history behind section 367, Congress' historical intent that no gain would be recognized on the transfer of foreign goodwill or going concern value to a foreign corporation, and the new administration in the White House, it is unclear whether the Final Regulations would survive a challenge to their validity.  Nevertheless, while the Final Regulations remain in effect, US transferors will need to carefully consider whether the section 367(a) or section 367(d) approach would be more beneficial for outbound transfers of foreign goodwill and going concern value.

***By Daniel W. Hudson, Miami***

## Treasury Issues Temporary Regulations Addressing Predecessors and Successors Under Section 355(e)

On December 19, 2016, Treasury issued temporary regulations (the "Temporary Regulations") that address when a change in control of a predecessor or successor to the distributing or controlled corporation in a spin-off transaction can trigger corporate-level gain under Code Section 355(e).  Treasury previously had issued proposed regulations addressing this topic in 2004 (the "Proposed Regulations").  The Temporary Regulations adopt the Proposed Regulations in large part, but make certain key changes to address taxpayers' comments on the Proposed Regulations.

Broadly speaking, section 355(e) provides that if a spin-off transaction is part of a plan that includes a change in control of the distributing corporation ("Distributing") or the controlled corporation ("Controlled") in the spin-off, then Distributing must recognize the built-in gain in the Controlled stock as of the date of the distribution.  Under section 355(e)(4)(D), this rule also is triggered if there is a change in control of a predecessor or successor of Distributing or Controlled, but the statute does not define what constitutes a predecessor or successor for this purpose.

The Temporary Regulations provide further guidance in this area with two main objectives. The first is to provide a comprehensive set of definitions that clarify when a corporation is a predecessor or successor of Distributing or Controlled. The second objective is to provide certain gain limitation rules that limit the amount of gain that Distributing must recognize under section 355(e) in certain spin-off transactions where there is a predecessor or successor of Distributing or Controlled.

The concept of a predecessor of Distributing (a "POD") is one of the key aspects of the Temporary Regulations. By contrast, whether a corporation constitutes a predecessor of Controlled is relevant only for very limited purposes in the Temporary Regulations.

The Proposed Regulations defined a POD as a corporation that transferred property to Distributing in a Code Section 381 transaction, but only if Distributing then transferred some, but not all, of the acquired property to Controlled in a transferred basis transaction. The Temporary Regulations broaden this definition in some respects, but narrow it in others.

The Temporary Regulations narrow this definition by treating a corporation as a POD only if its transfer of assets to Distributing and Distributing's transfer of some (but not all) of these assets to Controlled occurs as part of a plan. The concept of a "plan" is an important one in the section 355(e) context, so the Temporary Regulations largely rely on the existing regulations under section 355(e) to determine what constitutes a plan for purposes of the POD definition. This change from the Proposed Regulations generally will help taxpayers by reducing the burden that the Proposed Regulations would have otherwise imposed of tracking all of the assets that Distributing received in any prior section 381 transactions.

The Temporary Regulations also broaden the POD definition from the Proposed Regulations by no longer limiting PODs to corporations that transfer assets to Distributing in a section 381 transaction. Instead, a POD generally includes any corporation whose assets are divided as part of a plan as a result of some (but not all) of those assets being transferred to Controlled without the recognition of all of the built-in gain in the transferred assets. For example, unlike under the Proposed Regulations, a corporation can constitute a POD under the Temporary Regulations if it transfers assets to Distributing in a section 351 contribution, and those assets are then separated between Distributing and Controlled as part of a plan.

The Temporary Regulations define successors differently from predecessors. A successor is any transferee of the property of Distributing or Controlled in a section 381 transaction. The preamble to the Temporary Regulations indicates that Treasury is continuing to study whether to modify this definition, such as by treating a transferee in a Code Section 351 or Code Section 721 contribution as a successor in certain circumstances.

As described above, the second main objective of the Temporary Regulations is to limit the amount of gain that Distributing must recognize under section 355(e) in certain spin-off transactions involving predecessors or successors. The first gain limitation rule applies if there is a change in control of a POD as part of a plan that includes the spin-off transaction. In that case, the Temporary Regulations construct a hypothetical spin-off in which Distributing transfers to a hypothetical controlled corporation only the assets that Distributing received from the POD and that were actually transferred to Controlled. That is, the assets that Distributing transferred to Controlled that were not received from the POD are not considered to be transferred to the hypothetical controlled corporation in the hypothetical spin-off. The Temporary Regulations limit the amount of gain that Distributing must recognize under section 355(e) in this case to the amount of gain that would be recognized under section 355(e) in this hypothetical spin-off transaction. The effect of this rule is that when there is a change of control of a POD as part of a plan that includes the spin-off, the section 355(e) gain is limited to that portion of the section 355(e) gain that is attributable to the assets that Distributing received from the POD and that were separated as part of the spin-off.

The second gain limitation rule in the Temporary Regulations applies if a POD transfers assets to Distributing in a section 381 transaction, and the section 381 transaction results in a change of control of Distributing. This could apply, for example, if a POD merges into Distributing in a tax-free reorganization and the shareholders of the POD receive 50 percent or more of the stock of Distributing. In that case, the gain that Distributing must recognize under section 355(e) on account of this change of control is limited to the excess of the built-in gain in the Controlled stock over the amount of gain that Distributing would have recognized if there had been a change in control of the POD, but not of Distributing (taking into account the first gain recognition rule described above). The effect of this rule is to limit the section 355(e) gain that Distributing must recognize to the portion of the section 355(e) gain that is attributable to the assets of Distributing that it did not receive from the POD.

The final gain limitation rule in the Temporary Regulations provides that in a single spin-off transaction, the gain that Distributing must recognize under section 355(e) is limited to the built-in gain in the stock of Controlled as of the date of the spin-off. This rule could apply, for example, if there were changes of control of multiple predecessors and successors. Even if analyzing each of these changes of control separately would result in a larger income inclusion under section 355(e), the overall gain under section 355(e) for a single spin-off transaction cannot exceed the built-in gain in the Controlled stock.

Finally, the Temporary Regulations also address the interaction of the predecessor and successor rules with section 355(f). Broadly speaking, section 355(f) provides that section 355 does not apply to a distribution within an affiliated group if the distribution is part of a plan that includes another spin-off that is subject to section 355(e). The internal spin-off is therefore a taxable transaction. This can provide a benefit in some circumstances, as it ensures that an affiliated group recognizes section 355(e) gain only once in a planned series of spin-off transactions since the transferee in the internal distribution will have a stepped-up basis in the Controlled stock as a result of the internal distribution being a taxable transaction.

The Temporary Regulations provide that, unless the taxpayer elects otherwise, section 355(f) does not apply to an internal spin-off that is part of a plan that includes a change of control of a POD, provided that there is no change of control of Distributing, Controlled, or their successors. The purpose of this coordination rule is to permit the taxpayer to take advantage of the gain limitation rules described above. Without this rule, section 355(f) would cause the internal spin-off to be fully taxable, so the gain limitation rules in the Temporary Regulations would not apply.

Overall, the Temporary Regulations provide needed guidance on how to apply the predecessor and successor rules under section 355(e). Taxpayers planning a spin-off transaction should carefully consider whether any corporation could be considered a predecessor or successor of Distributing or Controlled under these rules.

***By Kirsten R. Malm and Adam T. O'Brien, San Francisco***

## US Formalizes Voluntary CbC Reporting Option

On January 19th, the IRS and Treasury issued Revenue Procedure 2017-23, which formalizes the United States' commitment to allow US parents of multinational groups to file Country-by-Country ("CbC") reports on a voluntary basis for tax years beginning between January 1, 2016, and June 29, 2016.

The voluntary filing can be submitted on IRS Form 8975 on or after September 1, 2017, either with the US parent's initial FY2016 tax return or as part of an amended FY2016 return. Taxpayers are encouraged to file Form 8975 electronically, to facilitate information exchange with foreign tax authorities. In December, the IRS published a draft version of Form 8975, but the final version of the form and its instructions are not yet available. They should be released in the coming weeks.

Under the final US CbC reporting regulations ("Final Regulations") issued in June 2016, CbC reporting is mandatory for US parents of multinational groups with revenues equal to or exceeding $850 million in the prior year, for tax years beginning on or after June 30, 2016, the day the Final Regulations were published in the Federal Register. The CbC report will provide aggregate, jurisdiction-wide information on a multinational group's global allocation of income, taxes paid and economic activity in each jurisdiction where the group operates, presented on a common template. For further detail, see Baker McKenzie North America Tax Client Alert, *Final US Regulations on Country-by-Country Reporting Implement OECD BEPS Action 13 for US Multinationals* (the "Client Alert"), distributed on July 20, 2016 and available under Insight at www.bakermckenzie.com/tax. However, the IRS and Treasury promised in the preamble to the Final Regulations that US parents with tax years beginning between January 1, 2016 through June 29, 2016, would be allowed to file the CbC report for their 2016 fiscal year on a voluntary basis.

The US will offer this option because the CbC report is a component of Action 13 of the OECD/G20 Base Erosion and Profit Shifting ("BEPS") project, and the OECD's Final Action 13 Report ("Final Report") recommends that countries adopt CbC reporting requirements for tax years beginning on or after January 1, 2016.

Pursuant to the Final Report, CbC reports should be filed by a multinational group's parent entity in its tax jurisdiction of residence, and the parent jurisdiction's tax authority will then provide the CbC report to the taxing authorities in all jurisdictions in which the group does business, pursuant to information exchange agreements. However, the Final Report also recommends that (i) if a parent jurisdiction does not require CbC reporting or (ii) if it does not have information exchange agreements in place with the relevant subsidiary taxing jurisdictions, the subsidiary tax authorities could instead require the local subsidiary(ies) to file the CbC report locally. Most of the 35+ foreign jurisdictions that have adopted CbC reporting requirements to date have followed the Final Report recommendations and require filing for fiscal years beginning on or after January 1, 2016, and also require subsidiary reporting if the CbC report is not available from the parent tax authority. Thus, US-parented multinational groups with parent tax years beginning before June 30, 2016, were at risk of having to file CbC reports in many different subsidiary jurisdictions (or, alternatively, having to designate a subsidiary as a "surrogate" parent for CbC reporting purposes, an option discussed further in the Client Alert).

US-parented multinational groups with tax years beginning before June 30th therefore have generally welcomed the opportunity to file their CbC report voluntarily in the US. The OECD has issued guidance encouraging foreign jurisdictions to accept parent CbC reports filed voluntarily, rather than requiring subsidiary or surrogate filing locally, provided that the following requirement s are met:

(i) the content of the filing must be consistent with the Final Report on Action 13;

(ii) the filing country must have CbC reporting rules in place by the filing deadline of the first CbC reports (December 31, 2017, for calendar year taxpayers in jurisdictions adopting the OECD recommended filing deadline; potentially earlier in countries, like the United States, that do not adopt the OECD recommended filing deadline. For example, US CbC reports will be due by the tax return filing date (with extensions) for the tax year covered by the report.);

(iii) the filing country must have a competent authority agreement in place with the relevant counterparty country by the CbCR report filing deadline providing for the exchange of CbC reports;

(iv) the filing country must not have notified the relevant counterparty country of a "Systemic Failure" (i.e., that automatic exchange has been suspended for certain reasons); and

v) the ultimate parent entity must have notified its tax jurisdiction of its intent to file voluntarily, and a resident constituent entity must have notified the relevant counterparty jurisdiction that it is not the ultimate parent entity nor the surrogate parent entity and provided the identity and tax residence of the reporting entity (unless those jurisdictions do not require such notifications).

Revenue Procedure 2017-23 does not impose any US notification requirements related to voluntary filing of the CbC report. However, if US-parented multinational groups plan to take advantage of the voluntary filing option in the US, they should check the laws of their foreign subsidiary jurisdictions to ensure that they have satisfied any notification requirements in those jurisdictions. In that regard, a number of jurisdictions have adopted rules requiring notification as to which member of the multinational group will be filing the report as early as the last day of the fiscal year covered by the report. Many of those jurisdiction also extended the first-year notification deadline, but notifications were required in Austria, Ireland, the Netherlands and Spain by December 31, 2016, for calendar year taxpayers. (For updated information regarding CbC reporting implementation and notification deadlines globally, please register for access to Baker McKenzie's CbC Reporting Implementation Guide at http://taxshare.bakermckenzie.com.

We note that filing the CbC report in the US voluntarily will only be sufficient to prevent subsidiary filing requirements from being triggered to the extent that the US has entered into competent authority agreements under an income tax treaty or information exchange agreement with the relevant foreign jurisdictions providing for the exchange of CbC reports before the CbC reports' filing deadline. The US has committed to putting such agreements into place in time. However, to date, no such agreements have been finalized, and the earliest non-US CbC report filing deadlines are less than 11 months away. Most non-US jurisdictions that have adopted or plan to adopt CbC reporting requirements have signed on to the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports ("the MCAA"), which was drafted by the OECD and provides for the exchange of CbC reports among all of its signatory jurisdictions. To date, 57 countries have become MCAA signatories. Treasury representatives have stated that the US will not sign the MCAA, but will instead negotiate CbC report exchange agreements bilaterally with all relevant jurisdictions. It is hoped that the US will be able to achieve this goal before the end of 2017.

***By Angela J. Walitt, Washington, DC***

# Temporary Regulations Address Outbounding Appreciated Property Via Related Partnerships

In 2015, the Treasury issued Notice 2015-54 (the "Notice"), announcing the intention to promulgate regulations attacking US taxpayer transfers of appreciated property to partnerships with related foreign partners. Treasury followed through on the Notice, releasing temporary regulations under Code Section 721(c) (the "Temporary Regulations") just two days before the incoming administration's regulatory freeze. The Temporary Regulations follow the general concepts of the Notice, such as requiring the remedial allocation method to defer gain, but with some meaningful taxpayer-favorable modifications.

## Section 721(c) Partnerships

The Temporary Regulations apply when a US individual, corporation, trust, or estate (a "US Transferor") transfers "Section 721(c) Property" to a "Section 721(c) Partnership." "Section 721(c) Property" is virtually all property having built-in gain, excluding cash equivalents, corporate stock or equity in widely held or publicly traded partnerships or trusts, debt instruments, certain financial derivatives and tangible property with less than $20,000 of unrecognized appreciation. Additionally, a partnership interest is not Section 721(c) Property if more than 90 percent of its assets (by value) are not Section 721(c) Properties. A "Section 721(c) Partnership" is a partnership where, after a contribution, a US

Transferor and one or more related persons (determined under Section 267(b) and 707(b)(1)) own 80 percent or more of the partnership's capital, profits, deductions or losses and one of the related persons is foreign. This definition is more restrictive than the definition that had been proposed in the Notice, under which a partnership would have been a Section 721(c) Partnership if more than 50 percent of the partnership was owned by parties related to the US Transferor. This narrowing of the scope of Section 721(c) was a material taxpayer-favorable change from the Notice.

## Gain Deferral Method

To avoid immediate gain recognition, the US Transferor and the Section 721(c) Partnership must agree to apply the Gain Deferral Method, pursuant to which:

- the partnership must use the remedial method for Section 704(c) allocations made with respect to the contributed Section 721(c) Property (the "Remedial Allocation Requirement");
- the Section 721(c) Partnership must allocate each book item of income, gain, deduction, and loss with respect to the Section 721(c) Property to the US Transferor in the same percentage, using what the Temporary Regulations refer to as the "Consistent Allocation Method;"
- the US Transferor must recognize remaining built-in gain with respect to the Section 721(c) Property upon the occurrence of certain "Acceleration Events;"
- the US Transferor must comply with extensive reporting requirements with respect to the contribution on an annual basis; and
- the US Transferor must consent to extend the period of limitations (the "Statute Extension") on the assessment of tax with respect to the contribution, allocations made to the US Transferor, and certain future contributions to the partnership.

There are two general exceptions where the Gain Deferral Method is not required: (1) a de minimis exception, when the sum of all of the built-in gain in all of the Section 721(c) Property contributed to the partnership during the partnership's taxable year is less than $1 million and (2) an exception for deemed transfers pursuant to partnership technical terminations under Code Section 708(b)(1)(B). There is also a partial exception for Section 721(c) Property that generates ECI, exclusively. When this partial exception applies, the Remedial Method Requirement and the Consistent Allocation Method do not apply. However, the US Transferor must recognize built-in gain as a result of an Acceleration Event and comply with the reporting requirements and the Statute Extensions. The most important thing to note about the Gain Recognition Method, under the Temporary Regulations, is that, unlike the rule proposed in the Notice, the Gain Recognition Method is applied on a property by property basis. The same pertains to Acceleration Events, so that an Acceleration Event with respect to one property is not a trigger for other properties.

## Special Rule for Anti-Churning Property

Normally, the remedial method may not be used with respect to pre-1993 Code Section 197(f)(9) property ("Anti-Churning Property") when partners in the partnership are related to the contributor of the Anti-Churning Property. When Section 721(c) Property is Anti-Churning Property, the Temporary Regulations will still require the partnership to make remedial allocations of income to the US Transferor. However, instead of remedial allocations of deduction, related non-contributing partners receive special basis adjustments, similar to a special basis adjustment under Code Section 743.

## Acceleration Events

Generally, an Acceleration Event is any event that would reduce the amount of remaining built-in gain that the US Transferor would recognize under the gain deferral method had the event not occurred or could defer the recognition of the remaining built in gain. The Temporary Regulations specify additional instances that are Acceleration Events: (1) a Section 721(c) Partnership's contribution of Section 721(c) Property to another partnership (unless, it qualifies as a successor event); (2) the contribution of an interest in a Section 721(c) Partnership to another partnership (unless, it qualifies as a successor event); and (3) any failure to comply with the Reporting Requirements, but only if the failure is willful. Moreover, at any time, a US Transferor may opt to trigger a deemed Acceleration Event.

## Exceptions to Acceleration Events

There are three categories of exceptions to Acceleration Events termination events, successor events and partial acceleration events. The Temporary Regulations list the specific events that pertain to each category. There is no Acceleration Event when there is a termination event of a successor event, but, after a termination event, the need to comply with the Gain Deferral Method terminates. After a successor event, the obligation on the US Transferor and the Section 721(c) Partnership to comply with the Gain Deferral continues with resect to the successor of the US Transferor or the Section 721(c) Partnership. Partial Acceleration Events are Acceleration Events, but only with respect to a portion of a Section 721(c) Property's built-in gain. After a partial Acceleration Event, the Gain Deferral Method is continued with respect to remaining built-in gain. There are two additional exceptions that do not fall into any of the categories above. One exception applies to outbound transfers to a foreign corporation, governed under Section 367, and the second exception applies to a US Transferor's (or an intermediate partnership's) transfer of a portion of an interest in a Section 721(c) Partnership where gain or loss is recognized.

### Tiered Partnerships

The Temporary Regulations introduce a regime for their application to tiered partnerships. One set of rules applies when a US Transferor contributes a partnership interest to a Section 721(c) Partnership. The second set of rules applies when a partnership, with a US Transferor as a direct or indirect partner contributes Section 721(c) Property to a second partnership. The tiered-partnership rules are highly complex so that even a summary analysis would be too extensive for the scope of this discussion.

### Reporting

Compliance with the Gain Deferral Method subjects the US Transferor to extensive and complex reporting requirements. First, for the purpose of reporting, the Temporary Regulations treat all Section 721(c) Partnerships as foreign partnerships, requiring a US Transferor to file Form 8865 to report contributions to and ownership of all Section 721(c) Partnerships, even when a Section 721(c) Partnership is organized in the United States. Oddly enough, however, a Section 721(c) Partnership organized in the United States will still be required to file a US return. The IRS has indicated its intent to update Form 8865 to include all of the information required under the Temporary Regulations.

***By Richard M. Lipton and Samuel Pollack, Chicago***

## IRS Discloses Proposed Partnership Audit Regulations

On January 19, the IRS sent long-awaited proposed partnership audit regulations for publication, although Federal Register publication has not occurred because of the January 20 Regulatory Freeze (*see* http://src.bna.com/lAj). The regulations propose to implement the most significant statutory change to partnership audit rules since 1982. The new entity-level audit rules were enacted by the Bipartisan Budget Act of 2015 (the “BBA”), and are mandatorily effective for tax years beginning on or after January 1, 2018, with optional application starting with taxable years beginning after November 2, 2015. The BBA rules dramatically increase the IRS power to assess and collect taxes involving partnerships by requiring the default tax assessment at the partnership level, by allowing a single partnership representative to agree to a tax assessment on behalf of all partners, and by dispensing with the requirement for the IRS or the partnership representative to notify partners of an IRS audit. Because the BBA rules also eliminated the TEFRA and Electing Large Partnership audit regimes, the IRS had an incentive to interpret the scope of the BBA rules very broadly to avoid doing individual partner audits, and that’s exactly what the IRS did in the new regulations.

The proposed regulations expanded on the statutory rules in the following ways:

### Narrowing the scope of the 100 or fewer K-1 exception

The BBA rules generally allow a partnership to elect out if there are 100 or fewer Schedule K-1s of the partnership being issued and the only partners are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or an estate of a deceased partner. The proposed regulations greatly narrow the scope of this exception by denying the under 100 Schedule K-1 exception if there is a disregarded entity or a grantor trust as a partner. Because it is common for partnerships to be owned through either upper tier partnerships, disregarded entities, or grantor trusts (for estate planning reasons), very few partnerships will be eligible to elect out of the new BBA rules.

### Expanding the scope of tax issues covered by the BBA rules

The BBA rules cover "any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof)", which is essentially items that show up on a Schedule K-1. However, the proposed regulations greatly expand the plain language of the statute to include all items of income, gain, deduction, loss, or credit, as well as other related items such as expenditures, tax preferences, exempt income, partnership liabilities, guaranteed payments, certain basis adjustments, character and the percentage of partnership interests, and items arising from the determination at the partnership level of partnership assets, investments, transactions and operations, such as investment tax credits and at risk rules.

Although this broader interpretation follows the general concepts proposed in a technical corrections bill (*see* https://www.congress.gov/bill/114th-congress/house-bill/6439/text*)*, it currently stands in clear contrast to the plain reading of the statute.

### "Push out" election and tiered partnerships

The BBA rules allow a partnership to avoid entity-level assessment by "pushing out" an audit adjustment under Code Section 6226, at a cost of adding 2 percent to the annual underpayment interest rate. There has been significant discussion as to whether the BBA statute allows such push out through upper tier partnerships. The proposed regulations note that expected technical corrections will address this issue and therefore the regulations reserve on this question until the technical corrections bill progresses.

### All penalty defenses must be raised in partnership audit

The partnership audit is the exclusive venue to raise penalty defenses, including partner-level reliance on advisor defenses. Thus under the new rules even though there is no requirement that a partner be told about the audit, any facts and circumstances penalty defenses specific to the partner are waived absent being raised in the partnership proceeding. This is the case even if the audit adjustment is "pushed out" to the partners under section 6226.

### Partners pay if the partnership doesn't

The proposed regulations answer the question of who is responsible for the tax if the partnership does not have sufficient funds to pay the tax, or the partnership is liquidated. In this case, the partners become personally liable for the audit adjustment and penalty, and interest obligations are allocated to the partners in the same manner as if the section 6226 election had been made to "push out" the adjustment to the partners. The section 6226 per-partner adjustment is essentially the amount of additional tax that would be owed by a partner if the tax had been correctly reported during the year under audit (plus interest and penalties).

### Partnership Representative Role

The IRS requires the partnership representative to be someone who is reasonably and timely available to meet the IRS in person, has a street address and telephone number in the US and can be reached during normal business hours, and has a US taxpayer identification number. Although an entity can be a partnership representative, that entity must designate a sole individual representative who meets the requirements above.

## Implications

The proposed regulations significantly elevate the importance of drafting partnership agreements to provide contractual protections between the partners. The partnership representative has unprecedented powers and partners will likely insist that the partnership agreement include partner rights to audit notification, audit participation, and input on IRS settlements and elections.

***By Steven R. Schneider, Washington, DC***

# Final PTP Regulations Define Qualifying Income

On January 19, 2017, Treasury and the IRS issued final regulations under Code Section 7704(d)(1)(E) (the "Final Regulations") to provide guidance with respect to publicly traded-partnerships ("PTPs") engaged in mineral and natural resource based activities. In sum, and as relevant to this article, for a partnership whose units are publicly traded to continue qualifying as a partnership, at least 90 percent of the partnership's income must be qualifying income derived from specified activities. The Final Regulations provide a framework for determining qualifying income.

The Final Regulations represent a marked improvement from the proposed regulations. Significantly, the Final Regulations dispense with the proposed regulations' "exclusive list" approach for qualifying income. Substantively, the Final Regulations provide considerable guidance related to the scope of each activity listed under section 7704(d)(1)(E) and the minerals or natural resource to which such activity can be applied. In that regard, the regulations use many technical terms and descriptions that, while helpful, will only be understood by persons with considerable expertise in the mineral and natural resource sector. The Final Regulations also provide additional guidance on the meaning of "intrinsic activities" (the concept of "intrinsic activities" is discussed in more detail below). Lastly, the Final Regulations provide a generous transition period to PTPs that will no longer generate qualifying income within the parameters section 7704 as clarified by the Final Regulations.

## Exclusive List

The proposed regulations provided an exclusive list of activities from which a PTP could derive qualifying income, and provided that the list could be revised as necessary. In response to widespread criticism, the Final Regulations eliminate the rigid and difficult-to-amend exclusive list and instead provide a general definition of the eight terms under section 7704(d)(1)(E) that give rise to qualifying income, namely, “exploration,” “development,” “mining or production,” “processing,” “refining,” “transportation,” and “marketing” of any mineral or natural resource. To supplement the definitions, for each of the listed activities, the Final Regulations provide a non-exclusive list of examples related to that activity.

The shift to a nonexclusive list is a welcome revision to the proposed regulations. Detailed nonexclusive definitions in the Final Regulations provide an adequate analytical framework from which a company engaged in mineral and natural resource activities can gauge the likelihood of its activities giving rise to qualifying income. Although the Final Regulations may help reduce taxpayers’ need to rely on private letter rulings (“PLRs”), the highly technical nature of the mineral and natural resource industry necessitates that the IRS will continue issuing PLRs under section 7704(d)(1)(E) as needed.

## Section 7704(d)(1)(E) Activities

In furtherance of the non-exclusive list, the Final Regulations provide general descriptions of each of the section 7704(d)(1)(E) activities, and to the extent certain activities require different definitions, the Final Regulations supply industry-specific sub-definitions. To that end, for “processing”, the Final Regulations provide industry-specific guidance applicable to natural gas, crude oil, ores and minerals, and timber. The Final Regulations do not define “refining” but instead provide industry-specific definitions for natural gas and crude oil, ores and minerals, and timber. Lastly, the Final Regulations provide that certain activities give rise to qualifying income because they are related to section 7704(d)(1)(E) activities, e.g., cost reimbursements for performing section 7704(d)(1)(E) activities (including back office cost reimbursements, maintaining and relocating assets, and other administrative type activities), blending activities, holding passive interests in mineral and natural resources, and additization activities.

The expanded definition of section 7704(d)(1)(E) activities encompasses many activities for which the IRS had previously issued favorable rulings (e.g., blending and additization), and confirmed that those activities give rise to qualifying income as a general matter. In addition, the Final Regulations confirm that many administrative activities and backoffice work will not require PLRs, and will not be challenged by the IRS. Overall, the expanded definitions are a helpful guide for taxpayers structuring their PTP operations.

## Intrinsic Activities

Services provided to companies engaged in qualifying income activities are not themselves per se qualified, but such services may generate qualifying income if they qualify as “intrinsic activities.” An activity is an intrinsic activity if: (1) the activity is “specialized” to support an activity that gives rise to qualifying income; (2) the activity is “essential” to the completion of the activity that gives rise to qualifying income; and (3) the activity requires the provision of “significant services” to support the activity that gives rise to qualifying income. The intrinsic activities test considers whether the service is unique to the industry, the magnitude of services required in furtherance of the qualifying income activity, and whether such services are legally or economically required.

The Final Regulations provide general guidelines and eight examples to assist taxpayers in determining whether an activity is an intrinsic activity. Whether an activity will be an intrinsic activity and thus give rise to qualifying income will be determined on a case by case basis that is very fact intensive. Taxpayers will continue having the option of requesting a PLR from the IRS in uncertain situations.

## Transition Period

The Final Regulations provide that PTPs that will not meet the qualifying income standards on a moving forward basis will have ten years from January 19, 2017 to restructure their operations. During that period, the PTP may treat its income as qualifying income if (1) it had received a qualifying income PLR from the IRS; (2) prior to May 6, 2015, the PTP had treated its income as qualifying income either (a) pursuant to a reasonable interpretation of section 7704(d)(1)(E) or (b) had entered into a binding agreement to construct assets to be used in an activity that would give rise to qualifying income pursuant to a reasonable interpretation of section 7704(d)(1)(E); or (3) the PTP engaged in activities that would give rise to qualifying income under the proposed regulations from the period beginning May 6, 2015, and ending January 19, 2017.

***By Steven R. Schneider, Washington, DC, Maher Haddad, Chicago, and Sam Kamyans, Washington, DC***

# Texas Court Rewrites the Tax Script for AMC

Although not all taxpayer disputes are dramatic, the Texas Court of Appeals has created quite a buzz in the Texas taxpayer community by revising its reasoning in a recently substituted opinion, *American Multi-Cinema, Inc. v. Hegar*, No. 03-14-00397-CV (Tex. App.—Austin Jan. 6, 2017) (“AMC”), for which it originally issued an opinion in 2015. Given the multi-billion dollar implications anticipated to result from the original opinion, it was not completely surprising that the court granted a motion for rehearing after it issued its original opinion; however, the court’s issuance of a substituted opinion underscores the drama that was anticipated to ensue if the original opinion had been allowed to stand. Although both the original and substituted opinions held in favor of the taxpayer, the original opinion could have had expansive consequences affecting not only the computation of the cost of goods sold (“COGS”) deduction, but also the determination of which taxpayers were considered to have a physical presence in the state. The substituted opinion was decided on a more narrow basis, averting the drama that could have resulted -- for now.

## Act I

AMC is the latest in a long line of litigation relating to the Texas Franchise Tax. AMC, the taxpayer, is a movie theatre chain. The case arose when AMC took a cost of goods sold deduction for exhibition expenses in its theatres as allowed in Tex. Tax Code § 171.1012. These deducted costs included expenses related to speakers, movie screens, movie production areas, and general theatre costs. The Texas Tax Code allows a COGS deduction when calculating the Texas Franchise Tax, but these "production costs" only qualify as a COGS deduction if the final product is tangible personal property. On audit, Texas disallowed AMC's deductions, arguing that by simply exhibiting a film, AMC was not producing a tangible good and therefore could not deduct these costs under Tex. Tax Code § 171.1012. Rather, the Comptroller argued, AMC was either providing a service or selling intangible property.

The Texas district court conducted the subsequent trial in two phases – first, to decide whether AMC was entitled to take a COGS deduction at all, and if so, to then decide which film exhibition costs actually qualified for the deduction. The district court held that AMC did indeed qualify for the COGS deduction because film exhibitions qualified as tangible personal property under the Texas Tax Code. However, the district court did not hold that all of AMC's expenses qualified for the deduction; rather, the court found that only costs related to speakers and screens qualified for the COGS deduction because they were costs to physically show (produce) the film. The district court held that other costs, such as general theatre expenses, were not production costs directly attributable to exhibiting the film as tangible personal property, but were instead "consumption" costs for the movie patron to enjoy the experience.

## Act II

Both sides appealed the trial court's opinion. The Comptroller argued that the trial court erred in its finding that AMC produced tangible personal property at all, and AMC argued that all of its expenses should be deductible as part of the production process, not just the costs relating to speakers and screens. In its original opinion, the Texas Court of Appeals granted AMC a complete victory, upholding the deductibility of all of the costs of film exhibition. The Court found that these film exhibition costs were deductible as COGS because each AMC film exhibition was indeed "tangible personal property" since a film exhibition is "perceptible to the senses." In response to the Comptroller's argument that film patrons left with nothing tangible after departing the theatre, the court noted that no "take-away" requirement exists for a product to qualify as tangible personal property.

Shortly after this court opinion, the Comptroller filed a motion for rehearing and publicly discussed the case, explaining that the case could cost Texas over $1 billon dollars annually, about 26 percent of the franchise tax's total collections, and over $6 billion in refund claims. (*See Franchise Tax Lawsuit Could Cost Texas $1.5 Billion a Year*, Josh Haney, FISCAL NOTES: A REVIEW OF THE TEXAS ECONOMY FROM THE TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, (June-July 2015), http://trcc.state.tx.us/fiscalnotes/june-july2015/amc-decision.php.) This annual dollar total reflected the large number of possible taxpayers who would now be eligible to claim a cost of goods sold deduction under the “perceptible to the senses” standard, while the refund amount reflected this annual total over four years, the statute of limitations for amended returns in Texas. This case quickly became one of the highest priorities for the Comptroller’s office.

## Act III

On January 6, 2017, after granting the motion for rehearing by the Texas Comptroller, the Texas Court of Appeals withdrew its original opinion and issued a substituted opinion. This substituted opinion reached the same holding as the original opinion; AMC could deduct not only the costs associated with speakers and screens, but it could also deduct all of its film exhibition costs, as these costs qualified as production costs, which were not mutually exclusive from non-deductible consumption costs. However, the court changed its reasoning in coming to this conclusion. Instead of concluding that each AMC film exhibition was tangible personal property because it was “perceptible to the senses,” as it held in its original opinion, the court now concluded that each film exhibition qualified as tangible personal property under legislation passed by the Texas Legislature in 2013. This legislation altered Texas Tax Code § 171.1012(a)(3)(A)(ii) to include various media products as “tangible personal property,” and this new definition included films.

## Critic’s Review

Although AMC might give the substituted opinion a five-star review, other historical Texas Franchise Tax taxpayers are likely giving the sequel two thumbs down when compared to the original. By removing its conclusion that the film exhibitions constituted tangible personal property because they were perceptible to the senses, the court has disregarded the reasoning it used in its original, withdrawn opinion. Certain taxpayers could have pointed to the original opinion for support that their products or services were tangible personal property because they were “perceptible to the senses” and that they were entitled to the COGS deductions – even if their products or services were not tangible personal property in the traditional sense. After the issuance of the substituted opinion, however, taxpayers can no longer use the AMC case as precedent to support this argument, although the argument could potentially still be raised.

If an expansive interpretation of tangible personal property to include everything “perceptible to the senses” was applied, a much wider range of taxpayers could qualify for the franchise tax COGS deduction. While this could benefit some taxpayers, who would now be eligible to take the COGS deduction and presumably reduce their Texas franchise tax liability, this expansive interpretation could potentially be troublesome for certain companies that did not file franchise tax or sales tax returns in Texas. If such companies were considered to have tangible personal property in Texas on a “perceptible to the senses” basis (e.g., asserting nexus over an internet publication or a radio or television broadcaster), the Comptroller could potentially contend that such companies would have a filing obligation in Texas – a position that could potentially result in much, much more drama.

Who knew that the term “perceptible to the senses” could be so exciting?

***By James M. Lucas, Dallas***

# Availability of Rectification in Tax Cases Limited By Supreme Court of Canada

In two companion cases, *Canada v Fairmont Hotels Inc.*, 2016 SCC 56 and *Jean Coutu Group (PJC) Inc. v Canada*, 2016 SCC 55, the Supreme Court of Canada (the "SCC") effectively reversed the liberal approach to the remedy of rectification in tax cases that had developed since *Juliar v Canada*, [1999] O.J. No. 3554 (On Sup Ct), affirmed [2000] O.J. No. 3706 (ONCA) by limiting the availability of rectification to errors in the recording of the terms of a prior agreement.

In Canadian tax law, form generally governs such that the tax consequences of a transaction flow from the legal documents. As a result, errors in legal documents can lead to unintended tax liability. Under the *Juliar* approach, rectification was available to correct legal documents that inadvertently failed to achieve a specific tax result intended by the parties. That is, rectification could potentially apply to remedy a legal document that contained the precise terms chosen by the parties, if those terms did not produce the intended tax result.

In *Fairmont*, the taxpayer entered into an arrangement that was intended to be tax neutral. A subsequent corporate reorganization frustrated the taxpayer's plan. On the mistaken belief that proper steps had been taken to preserve the plan, the arrangement was unwound, triggering a taxable foreign exchange gain. The Ontario Court of Appeal (the "ONCA") applied the *Juliar* test and found that the taxpayer had a continuing intention that the arrangement would be tax neutral; the taxpayer was not required to have determined the precise mechanics by which it would achieve this result.

The SCC overturned the ONCA's decision, setting out a much more restrictive test for rectification in tax cases. Pursuant to this new test, rectification is no longer available simply because the legal documents fail to effect the parties' intended tax outcome. Rather, there must be an error in recording a prior agreement with definite and ascertainable terms. Put another way, the parties must have chosen the correct mechanics, but erred in their implementation. The SCC further commented that the onus is on the party seeking to correct the mistake and that the evidentiary burden is high.

In *Jean Coutu*, the SCC considered rectification under the civil law (the law of the Province of Québec). Although the analysis differed slightly from that undertaken in *Fairmont* with respect to the common law remedy of rectification, the SCC ultimately found that the same test applied.

Following the SCC's decisions in *Fairmont* and *Jean Coutu*, the circumstances in which rectification will be available in Canadian tax cases are significantly narrower. In light of the requirement that the parties have a prior agreement with definite and ascertainable terms, and the need for clear, persuasive and cogent evidence of those terms, parties are encouraged to contemporaneously record both their intention and how they plan to achieve it.

***By Stephanie Dewey, Toronto***

# IRS Reduces RIC/REIT Built-In Gain Period to Five Years to Follow the PATH Act

On January 17, 2017, the IRS issued final regulations (the "Final Regulations") that reduce the length of time during which a regulated investment company ("RIC") or real estate investment trust ("REIT") may be subject to corporate level income tax on certain dispositions of property to conform with recent changes to the S corporation rules. The Final Regulations effectively align the built-in-gain ("BIG") recognition period for certain transfers of property by C corporations to RICs or REITs with the 5-year BIG recognition period set forth in the Protecting Americans Against Tax Hikes Acts of 2015 (the "PATH Act") and Code Section 1374(d)(7). Although the RIC and REIT rules had historically followed the same recognition periods as S corporations, the IRS had recently de-linked the recognition periods after the S corporation period was shorted by the PATH Act and the new regulations re-link them.

In general, when a C corporation transfers property to a RIC or REIT, either by qualification of such C corporation as a RIC or REIT or by the transfer of the C corporation's assets to a RIC or REIT (each a "Conversion Transaction"), the RIC or REIT will be subject to tax on any net BIG inherent in the contributed property under the rules governing S corporations in section 1374 and the underlying regulations. Under section 1374(a), if an S corporation was converted from a C corporation, the S corporation must pay tax on the net recognized BIG in its assets for any taxable year beginning in the "recognition period". Historically a period of ten years beginning with the first day of the first tax year for which the corporation was an S corporation, the PATH Act permanently adopted an existing temporary shortening of the recognition period in section 1374(d)(7) to five years beginning on such date.

The Final Regulations were issued in response to comments from the Chairmen and Ranking Members of the Ways and Means Committee of the US House of Representatives and the Finance Committee of the US Senate that existing temporary regulations issued on June 7, 2016, which removed the reference to section 1374 without updating the definition of recognition period, were inconsistent with congressional intent and the longstanding practice of treating RICs and REITs as having the same BIG recognition period as S corporations. By specifically providing that the term recognition period means the recognition described in section 1374(d)(7), the Final Regulations align the BIG recognition periods of RICs and REITs with the S corporation rules. Treas. Reg. § 1.337(d)-7(b)(iii). The recognition period continues to begin either on the first day of the RIC's or REIT's first taxable year (in the case of a Conversion Transaction resulting from qualification as a RIC or REIT) or on the day the RIC or REIT acquires the property (in other Conversion Transactions).

The Final Regulations apply to Conversion Transactions that occur after February 17, 2017, though taxpayers may elect to apply the 5-year recognition period from the Final Regulations for Conversion Transactions occurring on or after August 8, 2016 and on or before February 17, 2017.

***By Peter Matejcak, Chicago***

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# PFIC: Determining Ownership and Reporting Requirements Under New Regulations

Just before the New Year, Treasury and the IRS issued final regulations that provide guidance on determining ownership of a passive foreign investment company (PFIC) and certain annual reporting requirements for shareholders of PFICs. These final regulations essentially finalize the 2013 proposed regulations, withdraw the 2013 temporary regulations, and implement the rules announced in Notice 2014-28 (exemption for PFIC stock held through a tax-exempt organization or account) and Notice 2014-51 (PFIC stock subject to non-Section 1296 marked-to-market provision excluded from Section 1298(f) reporting requirement).

Ultimately, the Final Regulations do more to implement current guidance than provide additional insight into determining who is considered a shareholder of a PFIC and their annual filing requirements. That being said, there are certain clarifications to the definitions of “Shareholder” and “Indirect Shareholder” in the PFIC context as well as clarification and additional exceptions to Form 8621 reporting. For more discussion on these regulations, please see previously released Glboal Wealth Management Client Alert, *PFIC: Determining Ownership and Reporting Requirements Under New Regulations*, distributed on January 6, 2017 and available under Insight at www.bakermckenzie.com.

# Dividend Equivalent Developments Answer Questions and Raise New Ones

Taxpayers and withholding agents face challenges in complying with the withholding rules for dividend equivalent payments under Code Section 871(m). The challenges affect dealers, banks, parties with indirect exposure to US equities, withholding agents, and intermediaries. Congress enacted section 871(m) in 2010 and it became effective for certain types of contracts that year. However, the full scope of Section 871(m) has developed through guidance from Treasury and industry comments.

Several developments in late 2016 and early 2017 altered the landscape of section 871(m). The IRS released Notice 2016-76 addressing some open issues under section 871(m) on December 2, 2016. For a detailed discussion of Notice 2016-76, please see previously released Global Wealth Management Client Alert, *Transitional Relief for Equity-Linked Products But Challenges Remain*, distributed on December 28, 2016 and available under Insight at www.bakermckenzie.com. On December 30, 2016, the IRS released Rev. Proc. 2017-15, the final qualified intermediary agreement, which included qualified derivatives dealer rules targeting cascading withholding issues arising under section 871(m). Final and temporary regulations were published in the Federal Register on January 24, 2017.

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A memorandum from the White House Chief of Staff dated January 20, 2017 announced a regulatory freeze applicable to executive departments and agencies. The freezing order permitted the acting director of the Office of Management and Budge ("OMB") to grant exceptions in urgent circumstances. The IRS later released a statement indicating that the final and temporary regulations were published "as approved by the [OMB]." For further discussion, see the initial article in this newsletter, *The New Administration's Activities Related to Tax Administration*. The relationship between the freezing instruction and the final and temporary regulations remains unclear. It is possible that the Treasury Department could withdraw the regulations even if they were published in compliance with the freezing order.

## Join Baker McKenzie in Miami for the 18th Annual Latin America Tax Conference

The Firm's Latin America Tax Practice Group returns to Miami March 20-22, 2017 for the 18th Annual Latin America Tax Conference, being held at the Four Seasons Hotel. This not-to-be-missed program for in-house counsels, tax directors, accountants, and economists dealing exclusively or primarily with tax issues in Mexico and Latin America explores the rapidly evolving tax landscape in Latin America, the United States, and Europe. Join Baker McKenzie representatives from Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela as they discuss significant developments impacting the Latin America region, provide a comprehensive update on recently enacted transfer pricing regulations across the region as a result of BEPS, and offer an insightful look at the challenges of digitalization and artificial intelligence. For complete agenda and registration details, click here for the event invitation, or visit www.bakermckenzie.com/tax.

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