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Is Regulatory Reform Coming to Washington?

While President Trump's executive orders temporarily freezing the issuance of new regulations and requiring agencies to identify two regulations to eliminate for every new regulation that they propose and advisor Steve Bannon's statements about ensuring "the deconstruction of the administrative state" have garnered lots of attention, several bills are under consideration in Congress that could have a more transformative and long-lasting effect on administrative law.

Most of the activity related to changing the way regulations are developed and issued has occurred in the House of Representatives, which has held hearings and considered bills revising the regulatory process for several years in the recent past.

On January 5, 2017, the House passed H.R. 26, Regulations from the Executive In Need of Scrutiny Act of 2017 (REINS Act), which would require Congress to pass a joint resolution of approval before a major regulation can take effect. Non-major regulations will become effective unless Congress passes a joint resolution of disapproval. Congressional action under the REINS Act is not subject to judicial review. The bill also includes a "regulatory cut-go requirement," which requires agencies to repeal or amend an existing rule to completely offset the annual costs of any new rule on the US economy before the new rule may take effect. Finally, the REINS Act requires each agency to undertake an annual review of its existing rules and submit that review to Congress so Congress may determine, under the REINS Act's requirements for new rules, whether existing rules should remain in effect.

The REINS Act defines a major rule as one which the Administrator of the Office of Information and Regulatory Affairs in the Office of Management and Budget finds has resulted in, or is likely to result in, "(A) an annual cost on the economy of $100,000,000 or more, adjusted annually for inflation; (B) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (C) significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets." A non-major rule is any rule that is not a major rule. The REINS Act's definition of a "major rule" is similar, but not identical, to the definition of a "significant regulatory action" in Executive Order 12866. Regular readers of this newsletter may recall that IRS regulations are typically not designated as significant regulatory actions, based on the IRS's position that the economic impact comes from the statute and not the regulation.

Similar legislation includes H.R. 998, Searching for and Cutting Regulations that are Unnecessarily Burdensome (SCRUB) Act, which passed the House on March 2, 2017; H.R. 75, All Economic Regulations are Transparent (ALERT) Act of 2017; H.R. 41, Preventing Overreach Within the Executive Rulemaking System (POWERS) Act of 2017; and H.R. 462, Reforming Executive Guidance (REG) Act of 2017.

Upcoming Tax Events

Baker McKenzie/Bloomberg BNA Global Transfer Pricing Conference

Paris, France
▶ March 27-28, 2017

Washington, DC
▶ June 7-8, 2017

Financial Services Industry Tax Briefing Series

New York, NY
▶ May 2, 2017

14th Annual Global Tax Planning and Transactions Workshop

New York, NY
▶ May 9, 2017

Baker McKenzie North America Transfer Pricing Seminar

San Francisco, CA
▶ July 28, 2017

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

On January 5, 2017, the House passed H.R. 21, Midnight Rules Relief Act of 2017, which would permit Congress to identify multiple regulations in the same resolution of disapproval under the Congressional Review Act. Currently, the Congressional Review Act requires Congress to pass a separate resolution of disapproval for each regulations that it wants to prevent from taking effect.

In addition to bills that would change the process by which agencies issue regulations and give Congress greater oversight of regulations, the House has also passed legislation addressing judicial review of regulations. On January 12, 2017, the House passed H.R. 5, Regulatory Accountability Act of 2017, which, among other things:

- revises the Administrative Procedure Act to require agencies to make preliminary and final factual determinations based on evidence and to consider certain items (including reasonable alternatives to the proposed rule and the potential costs and benefits associated with any such alternatives),

- permits immediate judicial review of interim rules, other than in cases involving national security interests,

- removes *Chevron* deference (*Chevron* established a two-part test for courts' review of agency action: (1) does the statute unambiguously address the issue? If yes, the statute controls. If no, go to step 2. (2) Was the agency's interpretation of the ambiguous provision reasonable and not arbitrary, capricious, or manifestly contrary to the statute?) by requiring courts reviewing agency actions to decide all questions of law *de novo* and without deference to the agency's interpretation,

- amends rulemaking requirements and agency procedures that affect small businesses, and

- delays the effective date of "high impact" rules (those with an annual economic impact of $1 billion or more).

Requiring courts reviewing agency actions to decide all questions of law *de novo*, instead of applying *Chevron*, would be a dramatic shift in how courts review agency actions. The bill further provides that, if a court determines that there is a gap or ambiguity in the statute, the court shall not interpret that gap or ambiguity as (1) an implicit delegation of legislative rulemaking authority by Congress to an agency or (2) justification for deferring to the agency's interpretation of the statute or interpreting the agency's authority expansively.

None of the legislation in the House is explicitly targeted towards the IRS, nor does the legislation appear to be motivated by particular IRS regulations or other rulemaking activity. However, all of the House bills are broadly drafted and could apply to the IRS in the same way that they apply to other agencies.

The Senate's appetite for considering the bills passed by the House is uncertain. Several of these bills, or substantively similar legislation, has been passed by the House in previous Congresses, only to be ignored by the Senate. However, we understand that Senator Rob Portman (R-OH) plans to introduce the Regulatory Accountability Act, which would take a more moderate approach to changing the regulatory process than the REINS Act. Unlike the bills introduced in the House, Senator Portman's bill is intended to garner bipartisan support (which will be necessary to ensure passage in the Senate, due to the Republicans' slim 52-48 majority). Although the text of

Senator Portman's bill was not released by the time this article went to publication, it is expected to apply only to "significant regulatory actions" (and, thus, may not apply to most IRS regulations).

Taxpayers should pay close attention to these legislative developments—if enacted, the REINS Act and the Regulatory Accountability Act would dramatically change the process by which regulations are proposed and issued by agencies and reviewed by courts. These changes could lead to a better, more thorough explanation of Treasury and the IRS's reasoning and policy choices underlying specific regulations, but could also significantly slow the issuance of regulations as the IRS tries to comply with increased requirements imposed on a shrinking workforce. Moreover, if the Regulatory Accountability Act is enacted and courts are required to consider agency rulemaking *de novo*, taxpayers may find it easier to challenge the validity of IRS regulations in court.

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

House Republicans Plan to "Repeal and Replace" the Affordable Care Act

After much speculation about the contents of the Republicans' plan for "repealing and replacing" the Affordable Care Act (ACA), the House of Representatives introduced the American Health Care Act (the AHCA) on March 6, 2017. The AHCA is composed of two bills, which were marked up in the House Energy and Commerce and Ways and Means Committees on March 8, 2017. The bills passed both committees on a strict party-line vote in the early hours of March 9, 2017. The next step for the legislation is a markup by the House Budget Committee.

The health care portion of the AHCA, marked up by the House Energy and Commerce Committee, would (among other things) repeal the ACA's individual mandate, allow insurers to impose a surcharge on consumers whose health insurance coverage lapses, and repeal the ACA's Medicaid expansion provision in 2020 and replace it with a capped, per-capita block grant to states for Medicaid. The AHCA continues several popular provisions in the ACA, including prohibiting insurers from denying coverage to customers for pre-existing conditions, allowing dependents to stay on their parents' health plan until age 26, and prohibiting insurers from setting lifetime and annual limits on individual insurance coverage.

The tax portion of the AHCA, marked up by the Ways and Means Committee, repeals many of the taxes imposed by the ACA, including the tanning tax, the medical device excise tax, the 3.8 percent net investment income tax imposed on wealthy individuals, and the 0.9 percent increase in payroll taxes imposed on individuals with income greater than $200,000. In addition, the premium assistance tax credit under section 36B would be repealed and a new section 36C would be added, providing for an age-based refundable tax credit for premiums ranging from $2,000 to $14,000, which phases out as income increases. Finally, the "Cadillac" tax on high-cost employer plans (which will not be implemented until 2020 under current law) is delayed until 2025.

The Congressional Budget Office (CBO) released its cost estimate of the AHCA on March 13, 2017. The CBO estimated that the AHCA would reduce the federal deficit by $337 billion during 2017-2026 (government outlays would be reduced by $1.2 trillion, while revenues—mostly from tax receipts—would

decline $883 billion). CBO also estimated that, in 2018, 14 million more people would be uninsured under the AHCA than if current law remained in effect.

The AHCA is highly controversial. It's no surprise that Democrats in both houses of Congress have strongly criticized the bill (with House Minority Leader Nancy Pelosi charging that it's part of Republicans' plans to "Make America Sick Again"), but it's more important that there isn't consensus within the Republican party on whether the AHCA is the right path forward. Republicans who are part of the Tea Party caucus have expressed concern that the refundable credit in new section 36C would lead to a "new entitlement" and have threatened to vote against the legislation for that reason alone. Republican governors of states that expanded Medicaid coverage under the ACA are concerned that repealing that provision would lead to many uninsured residents in their states, while some Republican members of Congress think that provision should be repealed sooner than 2020. Despite this lack of agreement within the Republican party, Speaker Ryan intends to pass the AHCA out of the House and send it to the Senate for consideration before the Easter recess.

Stay tuned for an update in future newsletters as we follow this developing story!

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

The IRS Skips Statutory Procedures – The Tax Court Rules in its Favor

Code Section 6751(a) states, in no uncertain terms, that the Internal Revenue Service ("IRS") must "include with each notice of penalty . . . the name of the penalty, the section of this title under which the penalty is imposed, and a computation of the penalty." Further, section 6751(b)(1) provides unequivocally that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." (Emphasis added). Despite these Congressional mandates, the IRS agent in *Graev v. Commissioner*, 147 T.C. 16 (Nov. 30, 2016), assessed a penalty without approval of his immediate supervisor or showing the computation of the penalty. In a reviewed opinion, the Tax Court sustained the penalty.

The Graevs claimed on their 2004 income tax return a charitable contribution deduction for a property easement and claimed on their 2005 return a carryover of a portion of that deduction. An accountant prepared the returns and informed Mr. Graev that the donations were legitimate but highly visible to the IRS.

An IRS agent examined the 2004 and 2005 tax returns and concluded in 2008 that the charitable contribution deductions should be disallowed. In 2013, the Tax Court issued an opinion sustaining the IRS's disallowance of the charitable contribution deductions. See *Graev v. Commissioner*, 140 T.C. 377 (2013). He concluded that the 40 percent gross valuation misstatement penalty of Code Section 6662(h) (hereinafter, the "40 percent penalty") should be asserted. The agent prepared the Penalty Approval Form for the proposed 40 percent penalty. The form did not include a 20 percent penalty for an underpayment attributable to negligence under section 6662(a) and (b)(1) or a

substantial understatement of income tax under section 6662(a) and (b)(2) (hereinafter, the "20 percent penalty"). The agent's immediate supervisor approved the Penalty Approval Form as prepared. The agent prepared a proposed notice of deficiency determining the 40 percent penalty but not the 20 percent penalty.

The proposed notice was referred to the Office of Chief Counsel for review. On September 12, 2008, an attorney at the Office of Chief Counsel prepared a memorandum approving the proposed notice but proposing additional language stating that, alternatively, the Graevs were liable for the 20 percent penalty. The attorney signed the memorandum, and the attorney's immediate supervisor initialed it.

The IRS agent revised the notice of deficiency to include the alternative penalties, but his immediate supervisor did not approve the alternative penalties in writing. On September 22, 2008, the IRS issued a statutory notice of deficiency, revised as proposed by the attorney at the Office of Chief Counsel. The notice was signed by the Technical Services Territory Manager (i.e., not the immediate supervisor to the IRS agent). The notice disallowed the Graevs' contribution deductions relating to their contributions to NAT and determined deficiencies in taxes and penalties for both 2004 and 2005.

The notice contained a page on which the section 6662 accuracy related penalties were calculated. The 20 percent penalty computation required reducing the underpayment by amounts attributable to the 40 percent penalty issues in order to avoid stacking both penalties on the same underpayment. The underpayment to which the 20 percent penalty applied appeared as zero. In the section of the notice for the 40 percent penalty, the underpayment was not reduced by the alternative penalty, and the computation yielded an underpayment and a 40 percent penalty for both years.

In *Graev v. Commissioner*, 147 T.C. 16 (Nov. 30, 2016) ("*Graev II*"), the Graevs contended that the IRS failed to comply with the requirements of section 6751 as to the alternative 20 percent penalty. The Graevs asserted that a computation of the penalty must be included in the notice of deficiency and that the "initial determination" of the assessment of the penalty be "personally approved (in writing) by the immediate supervisor . . . or such higher level official as the Secretary may designate." Thus, the Graevs argued, these failures barred the assessment of that 20 percent penalty. In litigation, the IRS conceded that the 40 percent penalty did not apply. The Tax Court, in a split opinion, held that the notice of deficiency complied with section 6751(a) and that the Graevs' argument that the IRS failed to comply with section 6751(b)(1) was premature because the IRS had not yet assessed the 20 percent penalty. The Tax Court sustained the 20 percent penalty for 2004 and 2005.

Majority Opinion

Judge Thornton authored the majority opinion, joined by eight other judges. The Graevs first contended that the IRS failed to comply with the requirements of section 6751(a) because the notice showed zero amount for the alternative 20 percent penalty. The Court disagreed. The penalties in 6662(a) and 6662(h) were alternatives. Only one of these penalties could be applied to a given portion of a deficiency; they could not be stacked.

Even if the Graevs were correct that the IRS failed to include the 20 percent penalty calculation, the court found that the failure would not invalidate a notice of deficiency. The Court cited to a string of cases in which a procedural error or omission did not invalidate an administrative act or proceeding unless there was prejudice to the complaining party. Section 6751(a) did not provide a consequence for noncompliance if the IRS failed to include a computation of the penalty in the notice. The Court found that the Graevs failed to show that they were prejudiced by the IRS's failure to include a computation of the 20 percent penalty in the notice.

The Graevs also contended that the IRS failed to comply with 6751(b)(1), which generally required supervisory approval of the "initial determination of . . . assessment" of penalties. The Graevs contended that the IRS agent made the relevant initial determination, which was to impose the 40 percent penalty, not the 20 percent penalty. Thus, the 20 percent penalty was not "determined" by the agent, not approved by his immediate supervisor, and thus not assessable. The Court agreed with the IRS that the section 6751(b)(1) issue was premature. This case was a "deficiency case," which by definition concluded before an assessment could be made. An "assessment" was "the formal recording of a taxpayer's tax liability" on the IRS's records. Thus, the majority reasoned, assessment of the 20 percent penalties at issue in this case could not happen until the court's decision becomes final and un-appealable.

The petitioner had brought up several IRM citations. The Court however dismissed these, stating that IRM provisions "do not have 'the force or effect of law' . . . and do not create enforceable rights for taxpayers . . . ." Although the IRMs were "seemingly salutary," they were "immaterial" to the Tax Court's conclusion that the statute imposed no particular deadline for the IRS to secure the required written approval before assessing the penalty.

The Court stated that the effective date of section 6751(b) was governed solely by the "penalties assessed" term (and that section 6751(a) was governed by "notices issued"); therefore, the effective date provision showed that Congress intended that the written approval be in place as of the time of assessment, regardless of when the initial determination might have been made. The Court viewed section 6751(b) as having an "entirely prospective application." The legislative history convinced the court that section 6751(b)(1) focused on the assessment of penalties and that its redetermination of the 20 percent penalty was appropriate. The legislative history indicated that Congress enacted section 6751 because taxpayers were entitled to an explanation of the penalties imposed upon them and penalties should only be imposed where appropriate and not as a bargaining chip. The Court stated that it was premature to decide what additional burden, if any, section 6751(b)(1) might impose upon the IRS in assessing the deficiency as re-determined in the decision.

The Court then discussed the merits of the 20 percent penalty and concluded that the Graevs were liable for the penalty due to a substantial understatement of income tax for each year. Because the Court sustained the 20 percent penalty on the ground of substantial understatement, the Court stated that it did not need to decide whether the penalty should also be sustained on ground of negligence.

Concurring Opinion

The concurring opinion, in which two other judges joined, agreed with the majority's result but for a different reason. The concurring opinion stated that the actions of the IRS, even if not strictly complying with section 6751(b), did not prejudice the petitioners. Section 6751 was enacted to prevent IRS agents from using the prospect of penalties as either a threat or a bargaining chip against taxpayers, and the facts did not show the IRS using the penalties as such. The concurring opinion did not think that the elaborate analysis by majority and dissent were necessary, given that there was no prejudice to the taxpayers. The concurring opinion cautioned that the IRS should not abandon its current administrative practices and that the failure of the IRS to follow the statute or administrative practices may be challenged in a collection action.

Dissenting Opinion

Judge Gustafson authored the dissenting opinion, which was joined by four other judges. Gustafson made strong logical arguments on why the majority was incorrect (or at least inconsistent with how it treated violations of analogous Code sections). The dissent would not sustain the penalty because the IRS agent included a 20 percent penalty on the notice without first obtaining the approval in writing of his immediate supervisor, as mandated by section 6751(b)(1).

The dissent argued that the section 6751(b)(1) issue was not premature and that the majority ignored the nature of a deficiency case in the Tax Court. First, the Tax Court decided whether liabilities should be assessed. Tax Court deficiency cases necessarily occurred before any assessment of deficiency could be made. If the Graevs had not filed a petition, the IRS would have been obligated by Code Section 6213(c) to assess the deficiency. The Graevs' petition served as a "restriction on assessment." And when the Tax Court proceedings conclude, the re-determined deficiency must be assessed by the IRS. The dissent correctly compared this case with cases dealing with statute of limitations issues: the Tax Court was not shy in ruling on whether Code Section 6501 (statute of limitations) barred assessment and did not consider the issue premature, so why should section 6751(b)(1) be any different? When a rule such as section 6751(b)(1) barred assessment, the Tax Court could, and should, hold that the liability could not be assessed.

Second, for a penalty determined in a notice of deficiency, the supervisory approval required by section 6751(b)(1) must be obtained before the Tax Court suit was filed. The majority's reasoning – that section 6751(b)(1) contemplated that written approval was not required at any particular time before the assessment was made – was unwarranted. The dissent made a strong argument that, once the Tax Court petition was filed, the supervisor of the IRS agent lacked authority to approve or disapprove a penalty. In the Tax Court, the Chief Counsel, not the IRS's examination function, represented the Commissioner. Once the Tax Court decided the deficiency, the entire amount of the deficiency must be assessed, and the IRS had no discretion. Supervisory approval or disapproval after the decision would be meaningless. Moreover, section 6751(b)(1) required supervisory approval of the "initial" determination. The majority's interpretation in contrast would permit compliance when the IRS was making its final determination of the assessment.

Third, Code Section 7491(c) stated that the "burden of production in any court proceeding with respect to the liability of any individual for any penalty" "shall" be on the Secretary. Compliance with section 6751(b) was properly part of the burden of production inquiry in deficiency cases involving penalties. In light of section 7491(c), consideration of section 6751(b)(1) was not premature in a deficiency case. Fourth, the effective date of the statute did not support the majority's interpretation. Nothing in the regime suggested that supervisory approval under section 6751(b)(1) could be postponed until the moment of assessment.

The dissent also argued that the majority's interpretation would fail "utterly" to accomplish the purpose of the statute. The majority had concluded: "[T]he statute clearly contemplates that the written approval is not required . . . at any . . . particular time before the assessment is made." If that were true, then supervisory approval might be obtained after the Tax Court's deficiency case had been litigated; and in this case, it would still remain to be seen whether the IRS might yet obtain the necessary supervisory approval, so that the Tax Court could not decide in favor of the taxpayer and invalidate the penalty determination on this basis. In other words: the majority's interpretation would lead to absurd results. Once Chief Counsel had argued and the Tax Court had held that the taxpayer was liable for an assessment, the supervisor's "Johnny-come-lately" approval would add nothing to the process. And where the Tax Court had held the taxpayer not liable for the penalty, the supervisor's consideration of the matter would then be completely moot. In either circumstance, the dissent concluded, the statute would have accomplished "literally nothing" toward the congressional goal of assessing penalties only when appropriate.

Because the majority did not address the IRS's arguments, the dissent briefly addressed them. One of the arguments that the IRS had made was that the IRS Chief Counsel attorney could have made the "initial determination" and that the IRS was thus compliant with section 6751(b)(1). Temporally, it was the IRS agent, not the attorney at the IRS Chief Counsel, who made the "initial" determination. The dissent did not go as far as to conclude that an attorney at the IRS Chief Counsel could never make an initial determination. However, the Office of Chief Counsel typically served as an advisor to the IRS. In the Graevs' case, the attorney was giving advice to the IRS agent, not giving a determination. The attorney's memorandum giving legal advice, bore the following warning: "ANY UNAUTHORIZED DISCLOSURE OF THIS WRITING MAY HAVE AN ADVERSE EFFECT ON PRIVILEGES, SUCH AS THE ATTORNEY CLIENT PRIVILEGE." The giver of the legal advice in a Chief Counsel memorandum evidently understood the distinctively advisory nature of his work.

Lastly, the dissent argued that the failure to comply with section 6751(b)(1) was not "harmless error." The dissent agreed that the Graevs could not show prejudice due to the IRS's failure to show the 20 percent penalty calculation. However, the cases that the majority cited involved procedural lapses that made no provision for any consequence for noncompliance. In contrast, section 6751(b)(1) starkly provided a "consequence for noncompliance": "No penalty . . . shall be assessed unless" supervisory approval was obtained. This was a bar to assessment, an explicit consequence that Congress imposed for this particular procedural violation.

The dissent persuasively compared the language in section 6751(b)(1) to that of other sections of the Code. For instance, section 6501(a) was not worded more emphatically than section 6751(b). Had the assessment been "a mere one day late – or one hour late – in violation of section 6501(a)," the Tax Court would have enforced the statute of limitations without exploring whether the Graevs were actually prejudiced. In the same vein, if the Graevs had filed their Tax Court petition a mere one day late in violation of section 6213(a), the Tax Court would have dismissed the petition without inquiring whether the IRS's ability to defend against that petition was actually prejudiced. The dissent reasoned, where Congress had "decreed that the consequence of non-approval is that '[n]o penalty . . . shall be assessed', [the court] cannot interpose [its] judgment that in a given instance the non-approval was harmless or non-prejudicial and that therefore the penalty shall be assessed."

The dissent concluded by criticizing the majority for replacing a Congressional remedy for the "bargaining chip" abuse – non-assessment of the unapproved penalty, without regard its merit – with one that the court preferred. The dissent would have held that a failure to obtain the supervisory approval required by section 6751(b) barred an assessment, and that the omission of that approval could not be excused as harmless error.

Conclusion

Typically, taxpayers focus on the substantive arguments on why a penalty should not apply. While the majority in *Graev II* did not rule in the taxpayer's favor, the dissent showed concern that the IRS failed to comply with a statute to the taxpayers' detriment. Taxpayers may find it worthwhile to challenge procedural aspects of their penalty assessment in addition to their substantive aspects. And the dissent in *Graev II* made strong arguments that may help taxpayers in similar situations as the Graevs. The case will likely be appealed in the Second Circuit.

By Yea-Jin Angela Chang, Chicago

First Circuit Rules Against Taxpayer on STARS Transactions

The government won the latest rounds of litigation over a structured trust advantaged repackaged securities, or "STARS," and whether the transaction lacked economic substance. *Santander Holdings, Inc., v. United States*, __ F.3d __ (1st Cir. 2016). The First Circuit in *Santander* reversed a taxpayer win in the district court. See prior Tax News and Developments article, *Mixed Results on STARS Transactions* (Vol. 15, Issue 6, Dec. 2015), located under insight at http://www.bakermckenzie.com . The STARS transaction is one of a number of so-called "foreign tax credit generators" that has caught the attention of the IRS. Indeed, Treasury issued temporary regulations in 2008 and final regulations in 2010 to curb what it believed to be abusive tax structures. See prior Tax News and Developments article *Ease Over Equity - IRS Issues Final Regulations Aimed to Prevent Foreign Tax Credit Generators* (Vol. 11, Issue 4, Aug. 2011), located under insight at www.bakermckenzie.com.

The STARS Transaction

The STARS transaction was developed and marketed by Barclays Bank, PLC ("Barclays"), a UK-based bank, and KPMG. In simplified form, the STARS transaction operated as follows. The US taxpayer (or a related party) contributed income-producing assets to the STARS Trust (the "Trust"). The Trust then sold its shares to Barclays, and Barclays in turn loaned money to US taxpayer through the Trust.

The STARS transaction was designed to satisfy all US and UK tax requirements. For UK tax purposes, Barclays was treated as the owner of the Trust and was, therefore, entitled to claim deductions and credits against its UK taxes. For US tax purposes, however, the US taxpayer was treated as the owner of the trust and, therefore, US taxpayer claimed foreign tax credits for the UK taxes paid by Barclays on the trust income. Barclay's investment was intended to be debt for US tax purposes and equity for UK tax purposes.

The Court's Opinion

The First Circuit sided with the IRS argument, adopting the analysis from the Federal Circuit decision in *Salem Financial, Inc., v. United States*, 786 F.3d 932 (Fed. Cir. 2015). The IRS argued that the STARS transaction lacked economic substance and, consequently, the foreign tax credits attributable to the STARS transaction should be disallowed. The IRS treated the foreign taxes paid as expenses in determining that the taxpayer did not have a "pre-tax" profit on the transaction.

The taxpayer, on the other hand, argued that the STARS transaction had economic substance because the taxpayer entered into the STARS transaction to obtain low-cost funding for its banking business and it reasonably expected to earn pre-tax profits from the transaction. The taxpayers argue that before both US and UK taxes, the transactions earned a pre-tax profit.

The First Circuit followed the decision in *Salem*. The Court relied on *Salem* to distinguish the taxpayer's arguments related under *Compaq Computer Corporation v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries, Inc. v. Commissioner*, 253 F.3d 350 (8th Cir. 2001), that the taxpayer's transactions had economic substance because the transactions generated a pre-tax profit. The Fifth Circuit in *Compaq* and the Eighth Circuit in *IES* held that for purposes of the calculation of pre-tax profit, foreign taxes were taxes and not expenses of the transaction.

The First Circuit, quoting *Salem*, concluded that "the Trust transaction is not comparable to [investments in nascent technologies] because it does not 'meaningfully alter[] the taxpayer's economic position (other than with regard to tax consequences).'" The First Circuit agreed that the "U.K. tax was artificially generated through a series of circular cash flows through the Trust . . ." The court concluded that the "transaction was not a legitimate business and lacked economic substance." The First Circuit reversed the grant of summary judgment in the favor of the taxpayer on the primary issue. The government conceded the taxpayer was entitled to the interest deductions from the transaction. The First Circuit remanded the case to the district court for a trial on the penalties.

By Robert S. Walton, Chicago

IRS Issues New Final Qualified Intermediary Agreement

On December 30, 2016, the IRS released Rev. Proc. 2017-15, 2017-3 I.R.B. 437, which sets forth the final qualified intermediary withholding agreement ("2017 QI Agreement") under Treas. Reg. § 1.1441-1(e)(5). Although the 2017 QI Agreement is based on the proposed QI agreement from Notice 2016-42, 2016-29 I.R.B. 67 (released in July 2016) (the "2016 Proposed QI Agreement"), it contains several changes and clarifications that may significantly increase the operational burdens on qualified intermediaries ("QIs") subject to withholding and reporting requirements, including QIs seeking to become qualified derivatives dealers ("QDDs").

Under Treas. Reg. § 1.1441-1(b)(1), a withholding agent must withhold 30 percent on all amounts subject to withholding and payable to a foreign person unless it receives documentation that: (i) the payee is a US person; or (ii) the payment is made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding under a treaty or the Code. However, a withholding agent's responsibilities are generally reduced with respect to payments made to QIs (non-US financial institutions or clearing organizations acting as intermediaries that have entered into a QI agreement with the IRS). If a foreign entity is a QI, it must provide the withholding agent with a withholding certificate that contains certifications on behalf of its account holders for purposes of claiming reduced withholding rates. Treas. Reg. § 1.1441-1(e)(5)(i). Although the QI is required to obtain withholding certificates or other documentation from the beneficial owners of the payments as required by the applicable intergovernmental agreement ("IGA") (an agreement between the United States and another government that specifies the responsibilities of each party under the Foreign Account Tax Compliance Act ("FATCA")), it is generally not required to attach this documentation to the intermediary withholding certificate.

A QI agreement elaborates on the QI's withholding and reporting requirements, and authorizes foreign persons acting as intermediaries to simplify their federal tax withholding and information reporting obligations. In exchange for this simplification, however, the QI must implement procedures that identify investors in US securities.

The QI Compliance Program

Rev. Proc. 2017-15 explains that the 2017 QI Agreement expands on the compliance requirements from the 2016 Proposed QI Agreement and replaces the external audit requirement with the requirement to create a compliance program. The compliance program includes the appointment of a responsible officer to make periodic compliance certifications to the IRS and maintain the compliance program. The QI must also draft and update written policies and procedures that enable the QI to satisfy its obligations under the QI agreement. Additionally, the QI must train relevant personnel and ensure that systems and processes are in place to facilitate compliance with its obligations under the QI Agreement. The responsible officer must also arrange for an independent person to periodically review the QI's compliance with its QI agreement, including testing the QI's compliance with documentation, withholding, reporting, and other obligations. The reviewer can be external or internal but must be competent and independent. The 2017 QI Agreement also clarifies

that the periodic review will only include the accounts for which the QI is acting as an intermediary, as opposed to all accounts that could be subject to FATCA compliance.

The 2017 QI Agreement retains the consolidated compliance program provision contained in the 2016 Proposed QI Agreement. Under this program, QIs that are members of a group of entities under common control are permitted to designate a single QI to provide a compliance certificate on behalf of all QIs in the group if the QIs: (i) operate under a uniform compliance program; (ii) share practices, procedures, and systems subject to uniform monitoring and control; and (iii) are subject to a consolidated periodic review. The responsible officer must make the compliance certification for the consolidated group.

If a QI would be required to perform a periodic review of 50 or more accounts to determine its compliance with the relevant QI agreement, the 2016 Proposed QI Agreement allowed for the use of a statistical sampling of accounts (as opposed to a detailed review of each individual account). The 2017 QI Agreement retains the use of statistical sampling where the relevant QI has 60 or more accounts to review. A variety of methodologies can be used to conduct the statistical sampling, provided the methodology is documented.

Documentation Requirements

Prior versions of the QI agreement were unclear regarding the application of the presumption rules (and specifically, which set of presumption rules apply), a set of guidelines that are applied to determine the status of an account holder that has not provided sufficient information for a QI to determine its status (as a US or a foreign person) and the person's other relevant characteristics (e.g., as an owner or intermediary, as an individual, trust, partnership or corporation). The 2017 QI Agreement explains that if a QI is a reporting Model 1 foreign financial institution ("FFI") or a reporting Model 2 FFI and it does not have sufficient information to determine the FATCA status of an account holder, the FFI must obtain a self-certification to establish the account holder's status, and the certification must be consistent with the applicable IGA. If the QI is unable to obtain information or a self-certification, the QI must apply the presumption rules from Treas. Reg. § 1.1471-3(f) and treat the entity as a nonparticipating FFI. If an FFI has too many undocumented accounts, the US Competent Authority may determine that there is significant non-compliance and terminate the agreement.

Consistent with the prior QI agreements, a QI must use its best efforts to obtain documentation from account holders to determine whether a payment will be subject to withholding or is reportable. However, the 2017 QI Agreement imposes greater responsibilities on QIs and requires them to cure any conflicts that are contained in a payee's account file, even in circumstances where the QI has not received a withholding certificate that contains information that conflicts with the account file.

QDDs

In Notice 2016-42, the IRS introduced new provisions permitting certain QIs (including regulated equity derivatives dealers, regulated banks and bank holding companies, and certain entities wholly-owned by regulated banks and bank holding companies) to act as QDDs. The QDD regime addresses cascading withholding requirements that would otherwise apply to "dividend

equivalent" payments under Code Section 871(m), preventing the need for a withholding agent to withhold on certain payments made to the QDD when the QDD acts as a principal and provides a valid withholding certificate.

QDDs assume primary withholding responsibility for all payments made as a QDD, and the amount subject to withholding is not reduced by any taxes paid by the QDD. However, a QI can elect to assume primary withholding responsibility with respect to payments for which it is not required to act as a QDD.

Under the 2017 QI Agreement, a QDD's tax liability is equal to the sum of:

> (A) for each dividend on each underlying security, the amount by which its tax liability under section 881 for its section 871(m) amount exceeds the amount of tax paid by the QDD in its capacity as an equity derivatives dealer under section 881(a)(1) on that dividend, (B) its tax liability under section 881 for dividend equivalent payments received as a QDD in its non-equity derivatives dealer capacity, and (C) its tax liability under section 881 for any payments, such as dividends or interest, received as a QDD with respect to potential section 871(m) transactions that are not dividend or dividend equivalent payments to the extent the full liability was not satisfied by withholding.

QDDs are subject to additional reporting requirements (beyond those generally imposed on a QI). For example, QDDs are required to maintain a reconciliation schedule for section 871(m) amounts and must have written policies and procedures in place sufficient for the QI to satisfy its QDD tax liability. Rev. Proc. 2017-15 provides a phase-in process for QDD compliance with respect to the section 871(m) regulations and the relevant provisions of the 2017 QI Agreement. For the calendar year 2017, a QDD will be considered to satisfy QDD-specific compliance obligations under the 2017 QI Agreement if the QDD "made a good faith effort to comply with the relevant terms of [the 2017 QI Agreement]."

Application Procedure and Effective Dates

The QI agreement previously in effect expired on December 31, 2016. The 2017 QI Agreement takes effect on or after January 1, 2017. The effective date of the 2017 QI Agreement for a new QI applicant will depend on when the QI submits its application and whether the QI has previously received any reportable payments.

To become a QI, a prospective QI must submit the information specified in Form 14345 and establish, to the satisfaction of the IRS, that it has adequate resources and procedures to comply with the terms of the QI agreement. An entity that intends to become a QI for purposes of acting as a QDD must apply to enter into a QI agreement and include the information on the application relating to QDDs. If a QI wishes to renew its QI agreement and also act as a QDD, it must supplement its renewal request by providing all of the required information relating to QDDs.

By Ashleigh E. Hebert and Elaine Wilkins, New York

IRS Announces Large Business and International Campaigns

The IRS Large Business and International ("LB&I") division identified 13 initial campaigns in its effort to move to issue-based examinations and a compliance campaign process. LB&I identified the following 13 campaigns after analyzing data, taking suggestions from IRS compliance employees, and receiving feedback from the tax community.

The Code Section 48C Energy Credit Campaign ensures that only taxpayers whose advanced energy projects were approved by the Department of Energy and were allocated a credit by the IRS claim the credit. The treatment stream will be soft letters and issue-based examinations. Section 48C credits must be approved by the Department of Energy.

The Offshore Voluntary Disclosure Program ("OVDP") Declines-Withdrawals Campaign addresses OVDP applicants who applied for pre-clearance into the program but were denied access or voluntarily withdrew. Taxpayers who have not yet resolved their non-compliance and who meet the eligibility criteria are encouraged to enter one of the several offshore programs that are currently available. The IRS will address continued non-compliance with examination among other treatment streams.

The Domestic Production Activities Deduction Campaign focuses on multi-channel video program distributors ("MVPDs") and television broadcasters claiming that groups of channels are a qualified film eligible for a Code Section 199 deduction. Taxpayers are asserting they are producers of a qualified film when distributing channels and subscriptions packages, which often include third-party produced content. The campaign also takes issue with MVPDs claiming they provide online access to computer software for the customers' direct use through set-top boxes. LB&I developed a strategy to identify taxpayers impacted by these issues and will develop training to aid revenue agents in examination. The treatment streams for this campaign include developing an externally published practice unit, potential published guidance, and examination, if warranted.

The Micro-captive Insurance Campaign addresses transactions described in Transactions of Interest Notice 2016-66, in which a taxpayer attempts to reduce aggregate taxable income using insurance contracts and a related captive insurance company. Each entity treated as an insured entity claims deductions for insurance premiums. The IRS believes the manner in which the contracts are interpreted, administered, and applied is inconsistent with the arm's length principle. The treatment stream for this campaign will be issue-based examinations.

The Related Party Transaction Campaign focuses on transaction between commonly controlled entities that provide taxpayers a means to transfer funds from the corporation to related pass-through entities or shareholders. LB&I is allocating resources to determine the level of compliance in related party transactions for mid-market companies and will perform issue-based examinations.

The IRS will develop guidance to address uncertainties on issues regarding the life insurance industry pursuant to the Deferred Variable Annuity Reserves and Life Insurance Reserves IIR Campaign. The issues include amounts to be taken into account in determining tax reserves for both deferred variable annuities with guaranteed minimum benefits and life insurance contracts. The campaign's objective is to collaborate with industry stakeholders, Chief Counsel and Treasury to develop published guidance that provides certainty to taxpayers.

The Basket Transactions Campaign addresses structured financial transactions in Notices 2015-73 and 2015-74, in which ordinary income or short-term capital gains are treated as long-term capital gains based on a barrier event preventing recognition of income. LB&I's treatment stream for this campaign includes issue-based examinations, soft letters and practitioner outreach.

The Land Developers Completed Contract Method ("CCM") Campaign focuses on large land developers that the IRS believes are improperly using the CCM method of accounting. The IRS believes some developers in some cases are improperly deferring all gain until the entire development is completed. LB&I will train revenue agents regarding this issue. The treatment stream includes the development of a practice unit, soft letters, and issue-based examinations, if warranted.

The TEFRA Linkage Plan Strategy Campaign could provide significant changes as to how LB&I approaches terminal investors. The campaign focuses on developing new procedures and technology to work collaboratively with the revenue agent conducting the TEFRA partnership examination to identify, link and assess tax to the terminal investors that pose the most significant compliance risk.

The S Corporation Losses Claimed in Excess of Basis Campaign is due to LB&I's finding that S corporation shareholders claim losses and deductions that they are not entitled due to insufficient stock or debt basis to absorb the items. LB&I developed technical content to aid revenue agents examining the issue. The treatment streams for the campaign will be issue-based examinations, soft letters encouraging voluntary self-correction, stakeholder outreach, and creating a new form to assist shareholders in properly computing basis.

The Repatriation Campaign is based on different repatriation structures being used for tax free repatriations. LB&I has determined many taxpayers do not properly report repatriations as taxable events on their returns. The goal of the campaign is to improve issue selection filters while conducting examinations on identified, high risk repatriation issues in order to increase taxpayer compliance.

The Form 1120-F Non-filer Campaign identifies foreign companies doing business in the United States that do not comply with Form 1120-F filing requirements. LB&I data suggests many foreign companies doing business in the United States are not meeting filing obligations. The treatment stream will involve soft letter outreach, and if companies do not take appropriate action, LB&I will conduct examinations. The goal of the campaign is to increase voluntary compliance.

The Inbound Distributor Campaign focuses on US distributors of goods sourced from foreign related parties. LB&I believes many such US distributors' returns are not commensurate with the functions and risks assumed by US distributors. Under the arm's length principle, LB&I believes such US distributors are entitled to higher returns than the losses or small profits US distributors are reporting. LB&I developed a comprehensive training strategy for this campaign that will aid revenue agents examining this Code Section 482 issue. The treatment stream for this campaign will be issue-based examinations.

On March 7, 2017, the IRS held its first webinar to explain its new campaign-based approach to compliance. The webinar informed taxpayers as to how the IRS intends to conduct audits going forward and will likely guide Exam teams as well. For a full discussion of the webinar, including the impact of campaigns on the examination process, please see the previously released North America Tax Client Alert, *IRS Holds First of Eight Webinars on Campaigns*, distributed on March 10, 2017 and available under insight at www.bakermckenzie.com.

By Jonathan P. Talley, Chicago

CCA 201651014: A Twist on Convertible Debentures

Corporations, when seeking to raise working capital, have various options at their disposal. Each of these options can carry different tax considerations, especially with respect to the issuance of, and any subsequent events involving, the financial instrument at issue. Of course, the two main categories that describe many, if not all, of these options are: (1) debt instruments and (2) corporate stock. A corporation may also, as a variation on the former category, issue debt instruments that are convertible at some point in the future into equity shares of the issuing corporation.

A natural question is what are the tax consequences to both the debt holder and the issuing corporation when the debentures are converted to equity shares. The conversion is generally a nontaxable event to the debt holders. The question for the corporation is a bit more involved, especially where the bonds are issued for a discount and the issuer incurs other miscellaneous issuance costs. Code Section 162 generally allows a deduction for ordinary and necessary expenses paid during the taxable year in carrying on any trade or business. However, Code Section 263(a) requires that certain expenses be capitalized. Relevant here, Treas. Reg. § 1.263(a)-5(a)(9) requires that debt issuance costs be capitalized, and Treas. Reg. § 1.446-5 provides that these capitalized issuance costs are amortized over the course of the debt's term.

The next issue, from the corporation's perspective, is what happens for tax purposes when the debentures are converted into equity stock.

Rev. Rul. 72-348 – The Base Case

Rev. Rul. 72-348, 1972-2 C.B. 97 addresses, among other things, the treatment of unamortized bond expenses (both the issue discount and other expenses) at the time of conversion. Under the facts of the ruling, a corporation had issued outstanding bonds with a 10 percent discount off face

value that were convertible into stock. At the end of the taxable year in question, debt holders elected to convert their bonds into common stock of the corporation. At the time of conversion, the corporation had an outstanding amount of both unamortized discount and other unamortized debt issuance costs (e.g., commissions and other miscellaneous expenses).

The ruling held, based on the rationale of a number of prior cases, that the unamortized bond discount is no longer allowed as a deduction after the bonds are converted into stock. The ruling further held that, at the time of conversion, any unamortized bond expenses (i.e., debt issuance costs) assume the character of a capital expenditure under section 263 and are not deductible by the issuer as ordinary or necessary expenses of carrying on a business.

CCA 201651014 – The Twist

On December 16, 2016, the IRS released CCA 201651014 which addressed a variation on the typical convertible debenture scenario described in Rev. Rul. 72-348. In CCA 201651014, the Chief Counsel's advice was sought regarding the tax treatment of convertible debentures that differed slightly from the norm (i.e., debentures convertible into stock). In year one, a corporation ("Issuer") issued convertible debentures and incurred debt issuance costs which it capitalized and amortized over the term of the debentures. In year three, the debt holder exercised its right to convert the debentures into Issuer's warrants exercisable into Issuer's common stock. The warrants afforded the debt holder to purchase Issuer common stock for a certain amount per share. At the time of conversion of the debentures into warrants, Issuer sought to deduct the entire unamortized balance of debt issuance costs in the current taxable year.

The CCA first holds that: (1) warrants are treated as stock under Rev. Rul. 82-150, 1982-2 C.B. 110; and (2) Rev. Rul. 72-348 applies to the conversion (i.e., the debt issuance costs are not deductible).

As one counterargument, Issuer argued that it was entitled to deduct the unamortized costs on the grounds that Rev. Rul. 72-348 was now obsolete in light of the enactment of Code Section 108(e)(8). By way of background, Code Section 61(a)(12) includes income from discharge of indebtedness ("COD income") in gross income. Section 108 provides additional rules applicable to issuers and the amount of COD income to be recognized. In 1984, section 108(e)(8) was added, providing a general rule that when a taxpayer corporation issues stock for debt, that taxpayer is treated as having satisfied the debt with cash in the amount of the fair market value of the stock (i.e., a debt repurchase). Issuer argued that the enactment of this section obsoletes Rev. Rul. 72-348. The IRS did not agree, noting that section 108(e)(8) treats stock-for-debt exchanges as cash retirements only for purposes of determining whether a corporation has COD income, not for all purposes of the Code. If Congress meant the latter, it would have made that intention explicit in the statute.

Issuer also argued that 1997 amendments to Treas. Reg. § 1.61-12(c)(2)(i), defining the term "repurchase" to include the conversion of a debt instrument into stock of an issuer, supported its position. However, again, the IRS held that this definition of "repurchase" did not apply for all purposes of the Code, absent an explicit statement to that effect in the statute itself.

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As a last effort, Issuer argued that Treas. Reg. § 1.446-5, which by reference to other regulations, may require an issuer to allocate debt issuance costs as if they were original issue discount, allowed it to treat any unamortized debt issuance costs as repurchase premium that would be deductible. However, Treas. Reg. § 1.446-5 only applies to debt issuance costs that are deductible in the first place. Since the IRS already determined that Issuer's costs were not deductible under Rev. Rul. 72-348, this was a non-starter.

Whether debentures are convertible into stock or convertible into warrants which are exercisable into stock, the result is the same. Unamortized debt issuance costs remaining at the time of the conversion are not deductible. No exceptions.

By Christopher Furby, Palo Alto

The End is Just the Beginning: Implications of the DMA Settlement

On February 22, 2017, the Data & Marketing Association f/k/a Direct Marketing Association ("DMA") and the Colorado Department of Revenue (the "Department") entered into a settlement agreement, resolving the DMA's challenge to the Colorado use tax notification and reporting requirements enacted in 2010. Under the settlement agreement, the Department agrees that compliance with those use tax reporting requirements will not be required until July 1, 2017 and agrees to waive any and all penalties for non-collecting retailers who failed to comply with the use tax reporting requirements prior to July 1, 2017.

For more on the settlement agreement and the upcoming due dates for the notification and reporting requirements, visit www.saltsavvy.com to read the full post, *The End is Just the Beginning: Implications of the DMA Settlement*, by John Paek and Nicole Ford, published on March 14, 2017.

The Missouri Supreme Court Potentially Narrows Scope of "In Commerce" Sales Tax Exemption

The Missouri Supreme Court recently held in *TracFone Wireless, Inc. v. Director of Revenue* that the sale of telecommunications service from a seller in Florida to customers in Missouri did not qualify for Missouri's sales tax exemption for transactions made "in commerce." Despite the broadly-worded language of the "in commerce" exemption, the Court held the telecommunications services at issue were not in commerce as they were locally provided to Missouri customers. According to a footnote in the Court's opinion, taxpayers must show the out-of-state use was integral to the transaction in order for the transaction to qualify as "in commerce."

For more on the opinion and what it means for the future of Missouri's "in commerce" exemption visit, visit www.saltsavvy.com to read the full post, *The Missouri Supreme Court Potentially Narrows Scope of "In Commerce" Sales Tax Exemption*, by Maria P. Eberle and Julie Skelton Townsley, published on March 2, 2017.

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Baker McKenzie Returns to the Big Apple for 14th Annual Tax Planning Workshop

Join Baker McKenzie's global tax practitioners for the 14th Annual Global Tax Planning and Transactions Workshop, to be held at the New York Marriott Marquis on May 9, 2017. *Global Tax Planning Challenges and Opportunities in an Uncertain Political Landscape* will offer participants the chance to gain valuable insight into the issues that impact multinational companies amid the ever-changing tax landscape in the United States and Europe. This full-day workshop will highlight key legislative and regulatory developments during the plenary sessions, focusing on topics such as the current state of the US tax administration and the effects tax reform proposals may have on multinational companies, as well as how the Brexit vote shook up the European political landscape and the impacts of this new environment on taxpayer operating structures and tax planning. Corporate attendees will also have the opportunity to participate in interactive breakout sessions with our tax practitioners from around the world, as they examine key issues across three topical session tracks - Global Mergers & Acquisitions in the New Era, Cross-Border Planning, and Global Trends in Tax Policy.

For full conference details, agenda, and registration information will be available in the coming weeks. If you and your colleagues would like to ensure you receive an invitation directly, click here to submit your details.

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