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In This Issue:

The ACA Survives Republican Efforts to “Repeal and Replace,” But What Does That Mean for Tax Reform?

Tax Court Rejects IRS’s Indefinite Intangible Useful Life in Amazon Transfer Pricing Case, Just Like *VERITAS*

Sixth Circuit Reverses Tax Court’s Use of Substance-Over-Form Doctrine in *Summa Holdings*

2016 IRS APA Annual Report: Adapting to a Changing Landscape

UK Announcement on Multilateral Instrument Raises Questions Regarding the Practical Significance of the BEPS Proposed Changes to the Deemed PE Standard

Canadian Budget 2017: Awaited Changes Remain Just That…For Now

Canadian Federal Court of Appeal Rules CRA Cannot Force Taxpayers to Self-Audit on Uncertain Tax Positions

DC Office of Tax and Revenue Set to Relitigate Chainbridge Methodology in Oil Company Cases

Is South Dakota's Remote Sales Tax Case On Course to Achieving Its Ultimate Goal – Killing *Quill*?

Bloomberg BNA/Baker McKenzie Global Transfer Pricing Conference: Washington, DC - June 7-8

The ACA Survives Republican Efforts to “Repeal and Replace,” But What Does That Mean for Tax Reform?

After many legislative twists and turns, Speaker Ryan ultimately decided not to bring H.R. 1628, the American Health Care Act of 2017 (“AHCA”), to the House floor because the bill did not have enough votes to pass. Although President Trump and House Republicans have said that they will continue to work on health care reform and there have been ongoing legislative discussions between Vice President Pence and the Freedom Caucus, the White House and the House Ways & Means Committee appear to have shifted their focus to tax reform.

Health care reform and tax reform have many similarities, including that Congressional Republicans announced their intent to use the reconciliation process for both items, and health care reform was generally considered to serve as a “dry run” for tax reform.

Lots of ink has been spilled on post-mortem discussions about why Congress was not able to pass the AHCA in March, but the following lessons from the AHCA experience illustrate the path to a more successful outcome for tax reform:

1. President Trump should take policy leadership on the issue.

2. House Republicans should reach consensus on their approach to tax reform before introducing legislation.

3. It may be productive to consult with the Senate, in advance of introducing legislation, to determine the likelihood that the legislation can pass the Senate.

In the health care reform process, President Trump adopted the policy decisions made by Speaker Ryan and incorporated in the AHCA, rather than advancing his own reform proposals. There is general consensus that strong presidential leadership is required to successfully enact comprehensive tax reform, and President Trump has recently indicated that he intends to “drive the train” on the tax reform process. We understand that President Trump’s staff is working to develop a tax reform proposal and the President appears to have concrete goals that he hopes to achieve in tax reform. While the President’s staff is currently considering all options for tax reform, we expect the President to release a statement of principles for tax reform, perhaps as early as May. The recent announcement that David Kautter will be nominated to serve as Assistant Secretary for Tax Policy is a promising indication that the White House is filling out the administration’s tax policy staff, which will be useful in taking a lead role in the tax reform process.

One of the most challenging issues that the AHCA faced was the disagreement among different factions within the Republican party about the contents of the legislation. The AHCA generally was unpopular with multiple factions—moderate Republicans were concerned about the effects that the bill would have on

Upcoming Tax Events

New Corporate Tax Offence

Webinar
- May 4, 2017 (11 am EDT, 10 am CDT, 8 am PDT)

14th Annual Global Tax Planning and Transactions Workshop

New York, NY
- May 9, 2017

Baker McKenzie/Bloomberg BNA Global Transfer Pricing Conference

Washington, DC
- June 7-8, 2017

Register with corporate guest code BAKDC17

Global Transfer Pricing Workshop

San Francisco, CA
- July 28, 2017

Tax Planning and Transactions Seminar

Minneapolis, MN
- September 7, 2017

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

individuals who gained insurance through Medicaid expansion, while the House Freedom Caucus thought the AHCA did not go far enough because it did not repeal the Affordable Care Act in its entirety. Any effort to satisfy one group necessarily alienated the other because their goals were so divergent. When President Trump and Speaker Ryan decided to prioritize winning Freedom Caucus votes, they alienated moderate Republicans (some of whom changed their "yes" votes to "no") and were unsuccessful in getting the entire Freedom Caucus on board, leading the bill to ultimately collapse.

At this point in the legislative process, House Republicans do not appear to be as divided on tax reform as they were on health care. However, the AHCA largely incorporated many of the legislative proposals that were included in the House Republican blueprint for health care, and the divergent positions taken by different caucuses appears to have caught Speaker Ryan by surprise. For tax reform to be successful, any disagreements among Republicans about the appropriate legislative approach should be addressed while the legislation is being drafted, not after it is introduced. Chairman Brady's recent announcement that the Ways & Means Committee will hold hearings on the Blueprint should be helpful in this regard.

Furthermore, although the AHCA never went to the Senate for a vote, several Republican senators went on record to express their concerns with the AHCA and their unwillingness to vote for it as currently drafted. While Speaker Ryan and Chairman Brady are not obligated to coordinate with their colleagues in the Senate on drafting legislation, such coordination would certainly reduce the challenges faced by tax reform and speed up the legislative process.

Last but not least, revenue considerations will be front and center in any tax reform discussion. If the reconciliation process is used, tax reform must be revenue neutral at the end of the 10-year budget window. Considering the dramatic changes that House Republicans have proposed to the tax code, achieving revenue neutrality will be a challenging task. The failure to pass the AHCA only makes that goal more difficult to achieve because the AHCA would have reduced the baseline revenue projections that tax reform would need to meet for revenue neutrality by nearly $1 trillion. (The reduction would have come from the AHCA's repeal of many of the taxes associated with the ACA). In addition, the border adjustment tax ("BAT") from the House Republican blueprint for tax reform is expected to raise approximately $1.2 trillion over ten years. However, the BAT is controversial and Chairman Brady has acknowledged that, without the revenue generated by the BAT, House Republicans may only be able to lower the corporate income tax rate to 28%. It appears that President Trump's staff appreciates the difficulties of achieving revenue neutrality—Gary Cohn, chair of the National Economic Council, has emphasized that getting tax reform right is more important than the timing of when tax reform occurs.

Although many observers' expectations that the AHCA would serve as a "dry run" for tax reform were not met, the House's failure to pass the AHCA provides some valuable lessons that can be applied to tax reform. Whether President Trump can introduce a tax reform proposal and successfully rally Congressional Republicans around his vision should become more clear in the next few months.

By Alexandra Minkovich Washington, DC

Tax Court Rejects IRS's Indefinite Intangible Useful Life in *Amazon* Transfer Pricing Case, Just Like *VERITAS*

In March 2017, the Tax Court rejected the IRS's position in its transfer pricing dispute with Amazon.com, Inc. & Subsidiaries (collectively, "Amazon"). *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (March 23, 2017). The primary issue was whether Amazon appropriately valued a buy-in for pre-existing intangibles according to the 1995 Regulations that applied to cost sharing buy-in transactions. The Tax Court determined: (1) the IRS's buy-in valuation was arbitrary, capricious, and unreasonable; (2) Amazon's comparable uncontrolled transaction ("CUT") method, after upward adjustments, was the best method; and (3) Amazon's method for allocating intangible development costs ("IDCs"), after adjustments, was reasonable.

Summary of Findings of Fact

Amazon is an online retailer that exclusively sells products through Amazon.com and related websites. Since 2000, Amazon has sold both its own inventoried products as well as third-party products for which it received commissions. Amazon allowed third parties to sell items on its website through its "Marketplace" program that relied on Amazon's own proprietary website and software architecture. In exchange for a fee, Amazon also built and operated custom made e-commerce websites for merchants (*e.g.* Target) that allowed third-party merchants to sell their products on their own branded websites.

Before April 30, 2006, Amazon US owned most of the intangibles required to operate Amazon's European business, which at that time was siloed and consisted of several European subsidiaries, without a European headquarters. Amazon US licensed its intangibles to the European subsidiaries.

Amazon established a European headquarters ("Amazon Europe") with the goals of improving efficiencies, standardizing best practices, and streamlining fulfillment infrastructure to expedite expansion into additional European markets. In a series of transactions culminating on April 30, 2006, Amazon US transferred to Amazon Europe three groups of intangibles: (1) software and other technology intangibles required to operate Amazon's European websites, fulfillment centers, and related business activities (the "Technology IP"); (2) marketing intangibles, including trademarks, tradenames, and domain names relevant to Amazon's European business (the "Marketing IP"); and (3) European customer lists (the "Customer Lists"). Through the following agreements and transactions, Amazon Europe became a co-owner of Amazon US's intangibles: (1) the Cost Sharing Arrangement ("CSA"), whereby Amazon US and Amazon Europe agreed to share costs of further research, development, and marketing according to the proportion of benefits each was projected to derive from the cost-shared activities; (2) the License Agreement, whereby Amazon US granted Amazon Europe the right to Amazon US's Technology IP; and (3) the Assignment Agreement, whereby Amazon US granted Amazon Europe the right to Amazon US's Marketing IP and Customer Lists.

Because Amazon US was the sole owner of the Technology IP, Marketing IP, and Customer Lists, Amazon Europe had to make a buy-in payment to compensate Amazon US for the value of the pre-existing intangibles. Thereafter, Amazon Europe made annual cost sharing payments to compensate Amazon US for ongoing IDCs to the extent Amazon's IDCs benefited Amazon Europe.

The court found that innovative technology impacted every aspect of Amazon's retail business including creating and managing the catalog, displaying catalog items, conveying the look and feel of the website, convincing a potential customer to buy an item, processing the transaction and customer payment, shipping to the customer, and preventing fraud. In order to keep pace in a highly competitive and rapidly changing industry, Amazon had to innovate all the time.

Issues Presented

The court had to decide two issues: (1) the proper amount of Amazon Europe's buy-in with respect to the intangibles transferred; and (2) Amazon's IDC pool, for which Amazon Europe owed cost sharing payments.

The Parties' Positions

The IRS determined that the Technology IP, Marketing IP, and Customer Lists that Amazon US transferred to Amazon Europe had an indeterminate useful life and had to be valued as integrated components of an operating business rather than three distinct groups of assets (*i.e.,* applying an "aggregate approach" for the valuation). Accordingly, the IRS applied a discounted cash flow ("DCF") valuation methodology to Amazon Europe's expected cash flows and determined a buy-in payment of $3.5 billion owed to Amazon US.

Amazon argued that the IRS's DCF methodology was substantially similar to what the Tax Court previously rejected in *VERITAS Software Corp. v. Commissioner*, 133 T.C. 297 (2009). *See, e.g.*, previous *Tax News and Developments* article, *Tax Court Rejects IRS Coordinated Issue Paper on Cost Sharing Buy-ins in VERITAS* (Vol. 10, Issue 1, February 2010). Notably, the IRS asked the Tax Court to find that either *VERITAS* was a purely factual decision that had no bearing on *Amazon* or to overturn *VERITAS*.

Amazon contended the IRS's methodology treated short-lived intangibles as if the intangibles had perpetual useful lives, and therefore, improperly inflated Amazon Europe's buy-in payment. Amazon valued each category of transferred intangibles separately under the CUT method and determined the useful lives of the Technology IP and Marketing IP to be 6 years and between 8 and 20 years, respectively.

At trial, the IRS experts offered values for the various IP components that were even higher than the value that the DCF methodology produced. Specifically, the IRS experts valued the Technology IP, Marketing IP, and Customer Lists at $3.3 billion, $1.8 to $3.1 billion, and $215 million, respectively. Conversely, Amazon valued the Technology IP, Marketing IP, and Customer Lists at $117 to $182 million, $251 to $312 million, and $52 to $66 million, respectively.

Regarding the IDC pool, the IRS determined that 100% of the costs recorded to certain technology development and marketing cost centers must be allocated to IDCs, thus increasing Amazon Europe's cost sharing payments. Amazon argued that it properly allocated the cost center proportionately between development activities and non-development activities based on a section 41 qualified research expenditure study performed by PricewaterhouseCoopers (the "Section 41 Study"), such that only a percentage of the costs included in these cost centers were IDCs that Amazon US and Amazon Europe would share.

Tax Court's Opinion

The Buy-in

The Tax Court declined to overturn *VERITAS* and instead relied heavily on its earlier decision. Just as in *VERITAS*, the Tax Court held that the IRS's DCF methodology and perpetual intangible lives were arbitrary, capricious, and unreasonable. The court stated:

> One does not need a Ph.D. in economics to appreciate the essential similarity between the DCF methodology that Dr. Hatch employed in *Veritas* and the DCF methodology employed here. Both assumed that the pre-existing intangibles transferred under the QCSA had a perpetual useful life; both determined the buy-in payment by valuing into perpetuity the cash flows supposedly attributable to these pre-exiting intangibles; and both in effect treated the transfer of pre-existing intangibles as economically equivalent to the sale of an entire business.

The Tax Court found multiple flaws in the IRS's position. The IRS departed from the 1995 Regulations by not limiting the valuation of the buy-in to only include pre-existing intangibles. Second, the IRS valued the intangibles as if the transaction were "akin to a sale", which was an approach that Judge Foley rejected in *VERITAS* because items such as goodwill, going concern value, and workforce in place are not compensable intangibles under the Regulations. Third, despite the IRS's claims, aggregating the individual intangibles for valuation purposes was not appropriate because the 1995 Regulations require a transaction be respected as actually structured unless it lacks economic substance. The court found that Amazon's cost share arrangement had economic substance because the Regulations provided the right to cost share, and Amazon complied with the Regulations. Fourth, the "indefinite" useful life proposed by the IRS regarding Amazon's intangibles was not distinguishable from the "perpetual" useful life rejected in *VERITAS*. Finally, the IRS did not exclude cash flows attributable to subsequently developed intangibles, which artificially capped Amazon Europe's return despite co-owning the developed intangibles.

After finding the IRS's proposed assessment was arbitrary and capricious, the Tax Court had to determine the proper buy-in payment.

With respect to Technology IP, Amazon relied on internal CUTs between Amazon and third parties as part of Amazon's "M.com" program. The IRS's experts agreed Amazon's internal CUTs were a reliable comparable. The Tax Court found the proper unadjusted royalty rate was the median of the comparables provided by Amazon, 3.3%. The Tax Court then determined a downward adjustment of 25

basis points was appropriate due to Amazon Europe's sales volume to arrive at the starting royalty rate of 3.05% for Technology IP. Based on a source code analysis and testimony from Amazon's software engineers that confirmed Amazon's website architecture was undergoing rapid change in 2005, the court determined the Technology IP had a useful life of seven years with a 3.5-year "tail." As in *VERITAS*, the court determined that the 3.05% royalty rate must be ramped down according to the technology decay curve to account for the static nature of the original technology.

Regarding Marketing IP, Amazon relied on external CUTs, and Amazon's experts opined the useful life of the Marketing IP spanned 8 to 20 years. The Tax Court relied on four external CUTs that had a royalty rate range from 0.75% to 1%. Based on the strength of Amazon's brand, the court determined a 1% royalty (i.e., the high end of the range) was appropriate. The Tax Court found the useful life of Marketing IP to be 20 years due to Amazon's strong brand name in Europe. However, a perpetual useful life for Marketing IP was not warranted because the useful life of the Marketing IP was heavily influenced by the technological improvements essential to maintaining the value of those marketing intangibles, which needed continual refreshing to remain competitive. Finally, the Tax Court determined that 25% of the value of the Marketing IP should be excluded from the buy-in payment valuation because the European subsidiaries already owned a portion of the intangibles prior to the execution of the CSA as the European subsidiaries helped develop the value of the intangibles and took on significant market risk to do so.

The Customer Lists included customer names, email addresses, phone numbers, credit card information, and purchasing history. Amazon and the IRS agreed that internal comparables were appropriate to determine the arm's-length referral fees but disagreed as to the adjustments to be made to the comparables, including the period of time Amazon Europe would pay referral fees and whether using average or median customer spend was appropriate to predict future customer spending. The Tax Court determined that Amazon Europe would pay referral fees for ten years. The court also determined the average customer spend was correct because the median customer spend effectively excluded high-spending customers, which are the customers most desired by retailers, from the referral fee calculation. Based on these findings, the Tax Court determined a buy-in payment for the Customer Lists of $129 million.

Cost Share Payments

In order to determine Amazon Europe's proper cost sharing payments, the Tax Court had to decide the proper amount of IDCs to include in the cost pool. The IDC issue related to one cost center, and the Tax Court found the cost center's costs included a mix of both development costs and non-development costs because employees engaged in "substantial non-IDC activities, such as helping vendors list their products on Amazon's website, making minor adjustments to how website content is displayed, and managing third-party digital content that is viewed on or downloaded from Amazon.com." The Tax Court found Amazon allocated the costs on a reasonable basis according to its Section 41 Study, but the court made further modifications. The Tax Court stated, "For purposes of claiming

section 41 credits, it was in [Amazon's] interest to have its employees show the highest possible percentage of their time as allocable to R&E activities. All time allocated to R&E activities in the [Section 41 Study] will necessarily be allocated to IDCs."

Although the full impact of the Tax Court's opinion in *Amazon* is not yet clear, the court's elaboration on many of the principles articulated in *VERITAS* should provide further support for taxpayers relying on those cases in buy-in disputes under the 1995 Regulations. In addition, taxpayers should consider whether any of the principles addressed in the opinion may apply outside of the pre-2009 buy-in context."

By Jonathan P. Talley and Daniel B. Wharton, Chicago

Sixth Circuit Reverses Tax Court's Use of Substance-Over-Form Doctrine in *Summa Holdings*

A panel decision by the Sixth Circuit Court of Appeals reversed a Tax Court opinion and held that a taxpayer's Domestic International Sales Corporation ("DISC") commissions, distributed to two Roth IRAs, should not have been recharacterized as dividends to shareholders of the taxpayer under the substance-over-form doctrine.

The dispute centered around the taxpayer, Summa Holdings, and a DISC formed in 2002. DISCs, which are governed by Code Sections 991 through 997, were enacted by Congress as an export incentive. The central premise is that a company engaged in exporting goods can take a portion of the proceeds from those exports—as a minimum, up to 4 percent of gross receipts, or up to 50 percent of qualified export receipts—and contribute those proceeds to the DISC (a "DISC commission") without paying corporate income tax on the amount of the DISC commission. When the DISC makes distributions to its shareholders ("DISC dividends"), the shareholders pay tax at the qualified dividend rate.

Any entity may own shares in a DISC, and thus receive the DISC dividends. Shares of a DISC may also be owned through traditional IRAs and Roth IRAs. Generally, unless otherwise specified in the Code, Roth IRAs are treated exactly the same as traditional IRAs. The most important distinction between the two types of IRAs is how contributions and distributions are treated. The Code sections that apply to traditional IRAs allow taxpayers to deduct their contributions, but taxpayers must pay tax on distributions from those accounts. In contrast, the taxpayers do not receive a deduction for contributions to Roth IRAs, but distributions from a Roth IRA are tax-free. Thus, a Roth IRA allows for the tax-free growth of their retirement account. In exchange for that benefit, Roth IRAs have a yearly contribution limit, and that limit phases out to zero based on the annual income of the Roth IRA owner.

The Benensons owned Summa Holdings and the entities at issue. Summa Holdings was the parent company of a business that exported industrial products. In order to utilize the tax savings that could be derived from both the DISC and Roth IRA provisions, in 2001 the Benensons' sons, James III and Clement, established and funded their own Roth IRAs. Each Roth IRA then paid $1,500—book value—as the subscription price for 1,500 shares of stock in JC Export, a new

corporation which qualified as a DISC. Next, JC Holding was formed, which acquired the shares of the DISC from the Roth IRAs. Each Roth IRA then held a 50 percent share of JC Holding, which wholly owned the DISC.

Through this structure, Summa Holdings was able to pay a DISC commission to JC Export, and Summa Holdings was able to deduct the amount of the DISC commission from its taxable income. JC Export then paid a DISC dividend to JC Holding, on which JC Holding paid tax at the corporate tax rate. JC Holding would then distribute the balance of the DISC dividend to the two Roth IRAs.

In 2012, the IRS issued notices of deficiency for the 2008 tax year to Summa Holdings and the Benensons. The deficiency was based on the IRS's finding that the payments from Summa Holdings to JC Export were, in substance, dividends to Summa Holdings' shareholders, followed by gifts from these shareholders to the owners of the Roth IRAs. The IRS disallowed the deductions that Summa Holdings claimed for the DISC commissions it paid to the JC Export in 2008. The IRS also assessed an accuracy-related penalty against Summa Holdings under Code Section 6662.

In 2015, the Tax Court granted the IRS's motion for partial summary judgment. Its reasoning was based on the IRS's argument that the substance-over-form doctrine required the DISC commissions and DISC dividends to be recharacterized as dividends to the shareholders of Summa Holdings. The Tax Court held that Summa Holdings did not have a non-tax business purpose for the transactions at issue, and did not receive any economic benefit from the transactions. Therefore, the Tax Court found that it was proper to recharacterize the transactions to reflect their "substance"—deemed dividends to Summa Holding's shareholders, followed by contributions to the two Roth IRAs.

On appeal, the Sixth Circuit disagreed and reversed the Tax Court's decision. As the basis for its decision, the Sixth Circuit relied on Code Section 408A(a), which treats Roth IRAs in the same manner as traditional IRAs unless otherwise expressly stated. With regard to DISC dividends, the Code does not specify any different treatment. Furthermore, section 995(g) acknowledges that a DISC can be owned by an IRA by taxing DISC dividends received by an IRA as unrelated business taxable income. The Sixth Circuit emphasized that the IRS and taxpayer agreed that the taxpayer's selected form for the transaction complied with the literal provisions of the Code.

Because the transaction was compliant with the Code, the Sixth Circuit reasoned that the only way it could rule in favor of the IRS was if the substance-over-form doctrine applied. The Sixth Circuit then examined the history of the substance-over-form doctrine. It found that the basis for the substance-over-form doctrine did not apply in this case. "It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it," the Sixth Circuit wrote. "But it's quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance."

Here, the Sixth Circuit relied on what Congress allowed the taxpayers to do via the plain meaning of its statutes. "Congress designed DISCs to enable exporters to defer corporate income tax," the Sixth Circuit said. "The Code authorizes companies to create DISCs as shell corporations that can receive commissions and pay dividends that have no economic substance at all. By congressional

design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs."

Finding the same Congressional intent underlying Roth IRAs, the Sixth Circuit found that, "[w]hether Congress's decision to permit Roth IRAs to own DISCs was an oversight makes no difference. It's what the law allowed."

The Sixth Circuit further rejected another version of the substance-over-form doctrine set forth by the IRS as "a much broader (and more worrisome) version of the doctrine." In this version, the IRS postulated that, when two options for structuring a transaction existed, and the taxpayer chose the lower-tax option solely for the tax benefits, the IRS retained the power to recharacterize the structure in order to implement the higher-tax version. The IRS based this argument on the Supreme Court's 1945 decision in *Commissioner v. Court Holding Co.,* 324 U.S. 331, and argued that the IRS could recharacterize transactions, even those with economic substance, if they had no "valid, non-tax business purpose."

The Sixth Circuit rejected this proposition.

> [I]t's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. What started as a tool to prevent taxpayers from placing labels on transactions to avoid tax consequences they don't like runs the risk of becoming a tool that allows the Commissioner to place labels on transactions to avoid textual consequences he doesn't like.

The Sixth Circuit later continued:

> The Commissioner adds that the "critical point" of his argument is that the tax benefits Summa Holdings has enjoyed were "unintended by both the Roth IRA and DISC provisions." He may be right. And he may be right that permitting these DISC-Roth IRA arrangements amounts to dubious tax policy. But the substance-over-form doctrine does not give the Commissioner a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take.

The taxpayers were represented by Neal J. Block and Robert S. Walton, of Baker McKenzie LLP in Chicago, and by J. Timothy Bender, of Rotatori Bender Co., LPA in Cleveland.

By Daniel B. Wharton, Chicago

2016 IRS APA Annual Report: Adapting to a Changing Landscape

On March 27, 2017, the IRS issued its Announcement and Report Concerning Advance Pricing Agreements (Announcement 2017-03, I.R.B. 2017-15) ("2016 APA Report"), which presents the key results of the Advance Pricing and Mutual Agreement Program ("APMA Program") for calendar year 2016. The 2016 APA Report provides general information about the operation of the APMA Program, including staffing, and statistical information regarding the numbers of APA applications received and resolved during the year, including countries involved, demographics of companies involved, industries covered and transfer pricing methods ("TPMs") employed. This article summarizes the highlights of the 2016 APA Report and provides observations based on our experience with the APMA Program and APAs, both within the APMA Program and as tax counsel to companies in the APMA Program.

APMA Program Operations

APMA Program staffing in 2016 remained stable compared with the prior year, with 82 team leaders and economists and 10 senior managers. The IRS previously stated that it intended to increase APMA Program's staffing to approximately 65 team leaders (up from 63 for CY 2016) and 30 economists (up from 20 for CY 2016) to improve its case processing times, but IRS budget issues have resulted in an overall IRS hiring freeze. Further, significant changes in leadership continued during 2016, with a new Director of APMA (Acting) being appointed, as well as the restructuring of the IRS Large Business & International Division that "stood up" in February 2016. Management turnover and the then-impending restructuring, in addition to resource demands from the OECD-G20's Base Erosion and Profit Shifting ("BEPS") project, likely had an impact on internal operations, APA negotiations with companies and bilateral APA negotiations involving other countries' tax authorities, thereby requiring additional time to process certain types of APAs, as discussed below.

APA Intake and Output

New applications: APA filings dropped 46% in 2016 from the spike in 2015 (98 complete applications in 2016 vs. 183 in 2015). The decline in APA submissions is likely attributable to an artificially high submission rate in 2015 from companies desiring to avoid the application of the new revenue procedure governing APAs that the IRS issued in August 2015 and that went fully into effect on December 30, 2015. It is expected that, in 2017, the number of submissions could increase as a result of allowing bilateral APAs with India – more companies filed APA applications involving India in 2016 than any other jurisdiction – and increased desire for certainty.

With the 2015 spike in APA requests and a decline in executed APAs, pending APA inventory remained high at 398 for 2016, compared with 410 in 2015 and 336 in 2014. Pending bilateral APAs represented 81% of the total pending inventory.

In terms of the countries for which bilateral requests were filed, the 2016 APA Report shows a dramatic change, with most bilateral requests involving India (34%), followed by Japan (31%), Canada (8%) and Germany (7%). In 2016, Italy and the UK each constituted 4%, with 12% relating to all other countries combined. Another notable statistic regarding applications involves unilateral submissions. The percentage of unilateral submissions dropped to 14% of the total, as compared to 28% in 2014 and 2015.

Processing times: For APAs executed in 2016, average processing times increased slightly as compared to 2015. Some categories showed meaningful improvement, such as bilateral renewals. New bilateral APAs, however, took significantly longer to complete on average: 50.5 months in 2016 as compared to 40.6 months in 2015.

Executed APAs: The IRS executed the lowest number of APAs in 2016 (86) since 2011 (42). The mix of bilaterals and renewals was approximately the same as 2015, with 76% bilateral and 57% renewals.

As in prior years, the 2016 APA Report indicates that US-Japan bilateral APAs continued to constitute the largest percentage of overall APAs that the APMA Program processed (54%), followed by Canada (20%). The heavy caseload involving APAs with Japan, Canada and India is reflected in the number of APA teams that have responsibility for those APAs and shifts in the teams: two (instead of three in prior years) of the team leader groups have responsibility for APAs involving Japan (as well as other jurisdictions). Similarly, three of the team leader groups have responsibility for APAs involving Canada and India (as well as other jurisdictions).

Withdrawn APA requests: Companies withdrew significantly more APAs in 2016 (24) than 2015 (10). Several factors could be at play here, including a desire by APMA to “clean up” pending APA inventory or achieving certainty through other means. Similar to 2015, the IRS did not cancel nor revoke any APAs in 2016.

US vs. non-US parent companies: As with 2015, the majority of APAs continued to involve non-US parent companies: 65% of the executed APAs for 2016 were for non-US parent companies and their US subsidiaries, while 20% involved US parent companies and their non-US subsidiaries. The ongoing appeal of the APMA Program to non-US parent companies could be due to, among other things, the IRS’s continued focus on transfer pricing involving non-US parent companies, non-US parent companies’ desire for transfer pricing certainty, or an increase in audit activity in other countries for which a bilateral APA with the United States could help resolve.

Industries represented: As in 2015, most of the APAs executed in 2016 involved mainly manufacturing, with the next most common being wholesale/retail trade. Within the manufacturing segment, the computer and electronic products industry, the chemical and the transportation equipment industry were relatively equally represented (each having 6-7 APAs executed). To some extent, the year-over-year industry breakdown is random, in that it provides a snapshot of a particular twelve-month period, and many factors can impact the resolution timing for specific cases. The other industry classification that is prominent in the APMA Program is wholesale/retail trade, and merchant wholesalers of durable goods dominate that class year-over-year, with more than 50% of the total APAs in that category for all four years for which data is available.

TPMs applied: For 2016, the comparable profits method/transactional net margin method ("CPM/TNMM") continued to be the most commonly applied TPM for tangible and intangible property transactions (applied to 89% of such transactions, higher than in 2015). The most commonly used profit level indicator ("PLI") when the CPM/TNMM is employed was the Operating Margin (defined as operating profit divided by net sales), which was applied 67% of the time. The Berry ratio, ROA or return on capital employed PLIs were applied in the remaining cases. Unlike prior year reports, the 2016 APA Report does not separately state the number of times that PLIs other than the Operating Margin were used. Similarly, the 2016 APA Report does not include other data that had been provided in prior year reports, such as tested party functions and risks.

For services transactions, the most common PLI under the CPM/TNMM shifted back to the Operating Margin in 2016, which was used for 43% of the services transactions. In comparison, in 2015, 55% of the cases applied the Mark up on Costs, followed by 32% for the Operating Margin and 13% for the Berry ratio.

Asset intensity adjustments: It is the policy of the APMA Program to make the asset-intensity adjustments identified in the US regulations, i.e., receivables, inventory and payables, in all cases where such adjustments can be made. Where appropriate, property, plant and equipment ("PP&E") adjustments are made, but the percentage of cases where such an adjustment is made in any given year is a function of the specific facts of the cases that were resolved in that year.

APA terms: APA term lengths, including rollback years, averaged 6 years in 2016, slightly less than 2015 (7 years). The largest number of APAs were executed with five-year terms (60% of the total), and 87% had terms of 5 to 7 years. In 2016, 7 APAs had terms of 10 years or longer, which is lower than 2015 (more than 11 APAs). In addition to the impact of aging inventory, long term lengths can be a product of complex issues, difficult competent authority negotiations and the desire for prospective coverage. For example, when a difficult or contentious case reaches conclusion, often at the end or beyond the end of the requested term, both companies and governments may seek to extend the term of an APA and provide some prospectivity.

FX adjustments: The APMA Program has no set policy regarding adjustments to company financials to account for currency fluctuations. The 2016 APA Report notes, in that regard, "In appropriate cases, APAs may provide specific approaches for dealing with currency risk, such as adjustment mechanisms and/or critical assumptions." Over the years of the APMA Program, FX-adjustment mechanisms have been proposed by companies and by governments, and where the fluctuations are extreme or a currency has weakened significantly, this can be taken into account when shaping a bilateral agreement.

Observations and Conclusions

Changes in tax administration and companies' desires to address transfer pricing issues proactively affected the APMA Program during 2016 and will likely continue to do so. Some of these changes are positive and provide companies with additional avenues to resolve transfer pricing disputes, such as the growing inventory of APAs involving India. Also, as new leadership at APMA and LB&I's restructuring take hold, the increased stability should lead to improvements in training, case handling, processing times, etc. Resource constraints will continue

to be obstacles for the APMA Program and companies to overcome, placing an emphasis on creative approaches to moving cases through the pipeline. It is expected that the new APA revenue procedure, Rev. Proc. 2015-41, will improve the IRS's ability to process APAs, which is important as APA demand is projected to remain strong in light of the desire for certainty during a time of increased targeted enforcement, heightened transparency, BEPS pressures and more treaty partners implementing APA programs.

By Richard L. Slowinski and Donna McComber, Washington, DC

UK Announcement on Multilateral Instrument Raises Questions Regarding the Practical Significance of the BEPS Proposed Changes to the Deemed PE Standard

As the Multilateral Instrument ("MLI") signing ceremony approaches in June 2017, countries involved in the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Project are considering whether to adopt the proposed MLI treaty changes, with the UK indicating that it may not fully adopt the proposed deemed PE changes arising from the OECD 2015 Final Report on Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status* (the "Action 7 Report"). Countries that sign the MLI will use the MLI as the basis for implementing the BEPS Project treaty recommendations, which will modify the relevant parts of bilateral treaties currently in place. Notably, the MLI provides the individual countries with some flexibility in adopting the recommendations, as the BEPS Project did not include many of the proposed treaty changes, including the deemed PE standard, as "minimum standards." For a modification proposed in the MLI to be effective, both contracting states will have to agree to the same proposed change to their treaty. Taxpayers operating in contracting states that have signed the MLI will have to navigate the rules in the existing treaties, as modified by the MLI, including any reservations and observations by the states, when structuring their cross-border transactions.

In December 2016, the United Kingdom Treasury and HM Revenue & Customs ("HMRC") announced their recommendation that the UK Government not adopt some of the changes proposed in the MLI. The most dramatic recommendation in this regard was for the UK Government to not adopt the changes to the deemed agent PE rule in Article 5(5). These changes would broaden the standard from the existing "has, and habitually exercises . . . authority to conclude contracts in the name of the enterprise" to include cases where the dependent person "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." As reasons for this recommendation, the HM Treasury and HMRC emphasized the uncertainty and novelty of the new dependent agent PE standard and the attribution of profits work, and the complex administrative burden that would result from the change in PE standard, in exchange for little or no benefit to the UK Government coffers. Finally, HM Treasury and HMRC suggested that countries should be cautious in implementing the changes to the PE standard and consider whether it would be sensible to "wait and see" whether the proposed changes work well in practice.

In addition to the UK, there is considerable speculation that other countries, including some with extensive bilateral treaty networks, also may not adopt some of the Action 7 Report proposals. Thus, it is likely that identical activities of a dependent person (such as a sales and marketing local company) could constitute

a deemed PE of a non-resident supplier resident in one state, but not a deemed PE of a non-resident supplier resident in another state. In practice, this divergence complicates risk assessment and compliance under the PE rules for groups that choose to operate a consistent sales model in all countries, but which have multiple remote selling entities. Countries that seek to expand the definition of a deemed PE, but that are parties to treaties with countries that do not adopt the MLI changes, may be tempted to push the limits of the existing "habitually concludes contracts" rule. While aggressive jurisdictions could argue that the new "principal role" standard is not a distinctly different legal test, this is not the correct legal interpretation of the existing standard and would only increase the complexity and uncertainty for taxpayers.

For further insight into the UK announcement and the challenges facing the countries considering the MLI, please see *U.K. Announcement on MLI Raises Interesting Issues Regarding Different Deemed PE Rules in Important Treaty Networks*, by Gary D. Sprague, published by the Tax Management International Journal, Vol. 46, No. 3, p. 148, March 10, 2017 (available at www.bna.com).

By Juliana Marques, San Francisco

Canadian Budget 2017: Awaited Changes Remain Just That…For Now

On March 22, 2017, the Canadian Minister of Finance released the 2017 Budget (the "Budget"). Many tax practitioners expected significant proposals, including an increase to the capital gains rate and fresh law for goods and services tax/harmonized sales tax ("GST/HST") on digital products supplied by non-residents. Instead of the anticipated announcements, the Budget left all rates untouched, and made some small changes on various fronts. A few of these changes are highlighted below.

OECD BEPS Project

Canada will continue to work on implementing the minimum standards measures agreed upon under the Base Erosion and Profit Shifting ("BEPS") project. To that end, Canada is undertaking the necessary domestic processes to sign the multilateral instrument released on November 24, 2016 to streamline the implementation of tax treaty related BEPS recommendations; continues its commitment to improving the mutual agreement procedure in its tax treaties; and has begun the spontaneous exchange of tax rulings with other tax administrations.

Extension of Base Erosion Rules to Foreign Branches of Life Insurers

The Budgets proposes to extend the base erosion rules relating to the insurance of Canadian risks that are currently applicable to foreign subsidiaries of Canadian life insurers to foreign branches of Canadian life insurers.

De Facto Control of a Corporation

The Budget proposes to amend the *Income Tax Act* (Canada) (the "ITA") to expand the scope of factors to be considered in determining who has "*de facto* control" of a corporation. *De facto* control is relevant for, among other things, determining whether a corporation is a "Canadian controlled private corporation" (a "CCPC"). CCPC status is important because CCPCs are eligible for favorable tax treatment under the ITA, including a lower rate of income tax and access to the refundable R&D tax credit regime.

In general, a CCPC is a Canadian corporation that is not controlled *de jure* or *de facto* by one or more non-resident persons, one or more public corporations or any combination of the two. The proposed amendments will expand the group of persons who may be found to have *de facto* control of a corporation and will thereby further limit the number of corporations that will be eligible for the benefits afforded to CCPCs.

Mark-to-Market Election for Derivatives

The Budget proposes to introduce an elective mark-to-market regime for derivatives held on income account. Once the election is made, a taxpayer must include in its income the increase or decrease of its eligible derivatives on an annual basis. In addition, the recognition of any accrued gain or loss on an eligible derivative at the beginning of the first election year will be deferred until the derivative is disposed of. Consent of the Minister is required to revoke the mark-to-market election.

Straddle Transactions

A "straddle transaction" is an arrangement in which a taxpayer concurrently enters into two or more positions (normally, derivatives) that are expected to generate offsetting gains and losses. The taxpayer disposes of the position with the accrued loss before the end of its taxation year, realizing the loss. The gain position is disposed of early in the next taxation year. As a result, the taxpayer is able to defer recognition of the gain until the subsequent taxation year, while claiming the benefit of the loss in the initial year.

The Budget proposes to introduce a stop-loss rule to effectively defer the loss on the disposition of a position to the extent of any unrealized gain on an offsetting position, subject to certain exceptions.

Taxi and Ride Sharing Services

The Budget also proposed to broaden the definition of "taxi business" under the *Excise Tax Act* (Canada) to include a business of transporting passengers for fares by motor vehicle. This change is understood to apply to commercial ride-sharing services. This measure would mean that ride-sharing services will, like taxi operators, be required to register for and charge GST/HST on their fares.

By Valerie Duchesneau and Lesley Kim, Toronto

Canadian Federal Court of Appeal Rules CRA Cannot Force Taxpayers to Self-Audit on Uncertain Tax Positions

In *BP Canada Energy Company v. M.N.R.*, 2017 FCA 61, the Federal Court of Appeal placed important limits on the Canada Revenue Agency's information gathering powers. At issue was whether the taxpayer was required to provide internal accounting information identifying uncertain tax positions for which it had taken reserves for financial reporting purposes. The decision overturned a lower court order on the basis that the lower court had interpreted the governing provisions too broadly in the circumstances.

When acting for any purpose related to the administration or enforcement of Canadian income tax, the CRA is explicitly granted the power to:

> "inspect, audit or examine the books and records of a taxpayer and any document of the taxpayer or of any other person that relates or may relate to the information that is or should be in the books or records of the taxpayer or to any amount payable by the taxpayer under [the income tax statute]."

Canadian courts have interpreted this provision and others like it in a very broad manner. Under a broad reading, the rule appears to encompass a request for tax accrual working papers. In this case, the Court favored a narrower interpretation after carefully analyzing the provision alongside public policy considerations, financial reporting obligations, and the CRA's administrative guidance.

In particular, the Court relied on an unwritten rule that, although taxpayers must provide all reasonable assistance to tax auditors in the course of their audits, auditors cannot compel taxpayers to "self-audit" by revealing "soft spots" in their filing positions. This concept is tied to the principle that Canadian taxpayers are entitled to take the positions most favorable to them where an issue is reasonably open to debate. Here, the CRA appears to have been seeking the taxpayer's tax accrual papers as a roadmap for future tax audits, and without directly tying the documentation sought to issues under review. The Court concluded that allowing tax auditors such general and unrestricted access to tax accrual papers fell beyond the scope of the audit power granted by Parliament.

The Court's analysis also relied on the fact that provincial securities legislation requires accurate and reliable financial reporting for publicly-traded corporations and their subsidiaries. Notably, the national body representing Canadian accountants intervened in this appeal. They argued that routine and uncontrolled access to such tax accrual information would lead publicly-traded corporations to refrain from documenting issues for their external auditors and to be less candid in disclosing their tax risks. It was anticipated that this would result in less public protection due to decreased reliability of financial statements. The Court concluded that federal tax audit powers were not intended to imperil the integrity of the provincial financial reporting system, which indicated that general and unrestricted access to information on a taxpayer's uncertain tax positions was not authorized by law.

Although a welcome decision for taxpayers, the full scope of the legal principles underlying *BP Canada* is not yet clear. Future situations, and perhaps administrative or legislative responses to this case, may determine precisely whether and how the CRA may be permitted to compel taxpayer information on their uncertain tax positions.

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DC Office of Tax and Revenue Set to Relitigate Chainbridge Methodology in Oil Company Cases

Three District of Columbia taxpayers, ExxonMobil Oil Corporation, Hess Corporation, and Shell Oil Company (collectively, the "Oil Companies") recently suffered a setback in their fight against the District of Columbia Office of Tax and Revenue's ("OTR") reliance on a controversial transfer pricing methodology employed by Chainbridge Software LLC, the OTR's third-party transfer pricing "expert." On March 15, 2017, the District of Columbia Office of Administrative Hearings ("OAH"), in *Hess Corporation, et al. v. Office of Tax & Revenue*, Case Nos. 2012-OTR-00027, 2011-OTR-00047, 2011-OTR-00049 (D.C. Office of Admin. Hearings March 15, 2017), declined to apply the doctrine of offensive non-mutual collateral estoppel to the OTR and denied the Oil Companies' Motion for Summary Judgment. The Oil Companies had argued that the doctrine precluded the OTR from relying on Chainbridge's transfer pricing methodology because the OAH had previously determined in *Microsoft Corp. v. Office of Tax and Revenue,* Case No. 2010-OTR-00012 (D.C. Office of Admin. Hearings May 1, 2012), that the Chainbridge methodology was "arbitrary, capricious, and unreasonable." However, the OAH held that "exceptional circumstances" for application of the doctrine against a government agency did not exist.

For a full discussion of *Hess Corporation, et al. v. Office of Tax & Revenue* and the implications of the OAH's decision, please see *DC Office of Tax and Revenue Set to Relitigate Chainbridge Methodology in Oil Company Cases* on the SALT Savvy blog, available at www.saltsavvy.com.

Is South Dakota's Remote Sales Tax Case On Course to Achieving Its Ultimate Goal – Killing *Quill*?

South Dakota enacted legislation, S.B. 106, requiring retailers to collect and remit sales tax if they have annual sales exceeding $100,000 or 200 separate transactions. This legislation has been challenged by several taxpayers, and is working its way through the judicial process. *See South Dakota v. Wayfair, Inc.*, S.D. Cir. Ct., No. 32 Civ. 16-000092 (Mar. 6, 2017) ("*Wayfair*"). Most recently, the South Dakota Sixth Judicial Circuit Court granted the taxpayers' motion for summary judgment, finding S.B. 106 unconstitutional under *Quill v. North Dakota*, 504 U.S. 298 (1992). *Id*. The state has filed a notice of appeal and it appears that *Wayfair* may be heading to the South Dakota Supreme Court. Although anything is possible, if the South Dakota Supreme Court affirms the lower court, following *Quill*, this case is likely to be appealed to the U.S. Supreme Court. The U.S. Supreme Court would then have an opportunity to reconsider its 1992 *Quill* decision and the newly sworn-in Justice Gorsuch could be influential in determining whether *Quill* will ultimately be upheld.

For more discussion and insight on South Dakota's remote sales tax case and the kill-*Quill* movement, please see the SALT Savvy blog post from April 4, 2017, *Is the Kill-Quill Movement Gaining Momentum?*, available at http://www.saltsavvy.com/.

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Bloomberg BNA / Baker McKenzie Global Transfer Pricing Conference: Washington, DC – June 7-8

This June, Baker McKenzie joins Bloomberg BNA to present the Seventh Annual Global Transfer Pricing Conference at The National Press Club in Washington, DC. The two day conference, held Wednesday, June 7 and Thursday, June 8 will bring together Baker McKenzie global transfer pricing practitioners, along with non-US government and IRS officials, policy makers and leading industry experts to discuss the outlook of US tax reform, how multinationals can prepare for tax reform changes, and what the future has in store for US Transfer Pricing.

This year's conference highlights include:

- US Tax Reform discussion with top US government insider views on anticipated timing and the proposals that are likely to be included in the final package
- C-Suite executives and transfer pricing practitioners insight on what companies can do in their current tax planning to prepare for tax reform
- Large Business and International Division's recent 13 "campaigns" announcement and what it means in terms of risk assessments and potential adjustments
- Potential challenges arising from increased tax transparency (Country-by-Country reporting; Multilateral instrument)
- Advance Pricing Agreements update in the US, India, China and other key jurisdictions
- Recent transfer pricing litigation, lessons to be learned and the impact on transfer pricing

Agenda and registration details are available at https://www.bna.com/2017-global-transfer-pricing-dc. Register today using Baker McKenzie **corporate guest code BAKDC17** to receive a discounted rate of $1,095 (regularly $1,395).

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