Tax News and Developments
North America Tax Practice Group

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In This Issue:

Do Recent Administrative and Legislative Actions Clear a Path for Tax Reform?

Since our last issue, President Trump has released his one-page list of principles for tax reform and signed an executive order relating to IRS regulations, and the House passed the American Health Care Act and sent it to the Senate for consideration. Moreover, the President nominated an Assistant Secretary (Tax Policy) (see below). These actions may have cleared a path for tax reform by allowing the House to turn its attention back to tax reform and clarifying the President's views on what tax reform should include.

President Trump's Principles for Tax Reform

As we discussed in our last issue, Congressional Republicans are looking to President Trump to provide leadership on the parameters for tax reform. On April 26, President Trump released a list of core principles that he would like to see included in tax reform. *(See 2017 Tax Reform for Economic Growth and American Jobs, April 26, 2017)* For businesses, the President proposes to:

- Lower the business tax rate for corporations and partnerships to 15%
- Move to a territorial system
- Tax previously untaxed foreign E&P (deemed repatriation)
- Eliminate tax breaks for special interests

For individuals, President Trump proposes to lower the top income tax rate to 35%, repeal the estate tax and alternative minimum tax, and preserve the deduction for mortgage interest and charitable contributions while eliminating most other deductions. The standard deduction would be doubled.

While the principles bear some resemblance to the President's proposals on the campaign trail, there are some notable differences: the principles do not include the proposal from the campaign trail to allow taxpayers to elect current expensing in exchange for giving up the interest expense deduction and the principles propose a territorial system instead of the repeal of deferral that President Trump advocated for on the campaign trail. In addition, the principles are notably silent on whether the President supports the House Republican Blueprint's proposal for a Border Adjusted Tax ("BAT"), causing further confusion about that proposal's viability.

The White House has announced that it will hold listening sessions with stakeholders in May, and will continue working with Congress on tax reform. In addition, although several independent think tanks have projected that the proposals described in the principles would lose revenue (by as much as $7 trillion, according to some estimates), Secretary Mnuchin has said that the proposed tax cuts will result in increased economic growth, thereby paying for themselves.

Baker McKenzie

Upcoming Tax Events

Baker McKenzie/Bloomberg BNA Global Transfer Pricing Conference

Washington, DC
► June 7-8, 2017

For reduced conference rate, register with corporate guest code BAKDC17

EMEA Tax Conference

Munich, Germany
► June 8, 2017

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

It appears that Speaker Ryan and Chairman Brady intend to continue working on the House Republican Blueprint in the face of the President's proposals, although Speaker Ryan has suggested that the BAT was always intended to be revised through the legislative process. We expect the Ways & Means Committee to begin holding hearings on tax reform when the House returns from its recess. In addition, the Freedom Caucus recently expressed support for the President's principles and stated that it intends to begin drafting legislative language implementing those principles. Notably, the Freedom Caucus has announced that it does not believe that tax reform needs to be revenue neutral, in stark contrast to Speaker Ryan and Chairman Brady. In addition, Senate Committee on Finance Chairman Orrin Hatch recently indicated that he believes that it is not critical for tax reform to be revenue neutral. (https://www.bloomberg.com/news/videos/2017-05-04/hatch-revenue-neutral-for-tax-reform-not-critical-video)

Executive Order 13789

On April 21, President Trump signed an executive order (EO) *(see Presidential Executive Order on Identifying and Reducing Tax Regulatory Burdens, April 21, 2017)* instructing Secretary Mnuchin to review all significant tax regulations issued on or after January 1, 2016, and to work with the OIRA Administrator (an official within the Office of Management and Budget) to send a report to the President within 60 days identifying any such regulations that (1) impose an undue financial burden on US taxpayers, (2) add undue complexity to federal tax laws, or (3) exceed the IRS's statutory authority. What is treated as a "significant" regulation is not defined in the EO, although the EO explicitly states that earlier determinations of whether a regulation is significant under EO 12866 are not controlling. In other words, the EO applies much more broadly than just to the recent Code Section 385 regulations and could, in theory, apply to all regulations issued since January 1, 2016.

Within 150 days of the EO, Treasury is required to submit another report recommending specific actions to mitigate the burdens identified in the first report. Treasury shall take "appropriate steps" to delay or suspend effective dates of regulations or modify or rescind such regulations (including through notice-and-comment rulemaking). The EO requires that, if the "appropriate steps" are not taken within 180 days of the date of the second report, then Treasury shall publish, in the Federal Register, a progress report of actions taken to date.

Taxpayers who are concerned about regulations that are potentially subject to review under the EO should note that these timelines are aspirational, and should not count on reports being publicly available under the schedule set forth in the EO.

The EO also instructs Secretary Mnuchin and OMB Director Mulvaney to reconsider the exemption for tax regulations from the application of EO 12866. Regular readers may recall that EO 12866 establishes procedures for agencies to follow in promulgating regulations and grants OIRA the responsibility for reviewing all "significant" regulatory actions before they are published (typically, regulations are significant if they have an impact of $100 million or more on the economy). Under a longstanding memorandum of understanding between Treasury and OMB, most tax regulations are considered to be exempt from EO 12866. As readers may recall, Treasury and the IRS typically take the position that any economic impact comes from the statute, and not from the regulation.

The instruction to review the exemption from EO 12866 is a potential game-changer; if the exemption is revoked, then all tax regulations will be subject to OIRA review. This could have far-reaching effects on the amount of time that it takes to issue tax regulations (because OIRA does not have expertise in reviewing tax rules or sufficient staff currently dedicated to reviewing the volume of tax regulations that are published), although it may also have positive results on future tax regulations. For example, OIRA has more experience in preparing and reviewing analyses of the burden(s) imposed by a regulation than the IRS, and expanded OIRA review could improve the quality of burden analyses in tax regulations. In addition, because OIRA has responsibility for reviewing regulations across the federal government, increased OIRA review could also result in increased conformity with administrative law requirements in issuing tax regulations.

House Passes the American Health Care Act

On May 4, the House narrowly passed the American Health Care Act (with amendments) by a vote of 217-213 (*See H.R. 1628 – American Health Care Act of 2017, May 4, 2017*). The bill, which had not been scored by the Congressional Budget Office by the time of the House vote, now goes to the Senate for its consideration. The CBO has stated that it expects to release its score the week of May 22nd.

Passing a health care bill out of the House has implications for tax reform: the House is now free to turn its attention back to tax reform, while the Senate Finance Committee will likely need to redirect some of its resources from tax reform to health care. Although it is beyond the scope of this article, the Senate is expected to make significant changes to the bill passed by the House and the Senate could spend as much time as the next two months focusing on health care. This activity could delay the Senate's ability to take up tax reform.

Client Considerations

Clients who have concerns about recently-issued regulations should consider whether to engage with the Treasury Department as it reviews regulations under EO 13789 and advocate for the withdrawal or revision of regulations. In addition, although EO 13789 does not technically apply to notices, we understand that Treasury is amenable to reviewing other forms of guidance besides regulations under EO 13789 and clients that have concerns about recent notices should consider identifying those notices to Treasury for its review. It is unclear whether the Treasury's Office of Tax Policy will play a significant role in determining whether and how to repeal or revise such guidance.

As the House turns its attention back to tax reform, clients should consider developing their strategies for Hill engagement during the public hearing and legislative drafting process.

Nomination and Staffing News

President Trump nominated David Kautter, Partner-in-Charge of the Washington National Tax practice for RSM (an audit, tax and consulting firm) to serve as Assistant Secretary (Tax Policy). Mr. Kautter spent the majority of his career with EY. We also understand that Treasury will fill the deputy positions under the

Assistant Secretary (Tax Policy) before Mr. Kautter is confirmed. This will help Treasury restart the regulatory process.

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

Recent Helpful North/South and M&A Guidance from the IRS

Revenue Ruling 2017-9

On May 3, the IRS released Rev. Rul. 2017-9 (the "Revenue Ruling"). The Revenue Ruling provides guidance to taxpayers concerned that transactions meant to qualify for tax-free treatment under Code Section 355 may be recharacterized as a partial sale or exchange (a so-called "north-south" transaction"). The Revenue Ruling discusses two similar sets of transactions (the "Situations") which involve a section 355 distribution occurring after some number of restructuring transactions.

Each of the Situations involves a similar structure. There are three corporations: a controlled corporation ("C") which is wholly owned by a distributing corporation ("D") which is wholly owned by a parent corporation ("P").

The Transactions

In the first set of transactions ("Situation 1"), C directly operates a trade or business ("Business B") which satisfies the active trade or business requirement under section 355(b)(1)(A). D does not have an active trade or business meeting such requirement. To satisfy the active trade or business requirement, P contributes Business A consisting of property worth $25X to D immediately prior to D distributing all of the shares of C worth $100X to its shareholder, P. The Revenue Ruling considers whether the contribution of Business A to D, intended to be a tax free contribution under section 351, and the distribution of C to P, ostensibly tax free under section 355, should be respected as two discrete transactions. Alternatively, if the transaction were to be treated as a "north-south" transaction, the transaction would be characterized as an exchange of Business A for 25% of the shares of C. Accordingly, the distribution of the remainder of the shares would be treated as a distribution by D to P of 75% of the shares of C, failing to meet the "distribution of 80% control" requirement of section 355(a)(1)(D). This distribution would then be a taxable distribution subject to sections 301 and 311.

The IRS held that the contribution and the distribution are separate and distinct transactions. Thus, the contribution is tax free and the distribution is tax free. The IRS explained that steps of a transaction should only be integrated after considering the scope and intent embodied by the portions of the Code which may be implicated. Based on this, the IRS reasoned that the contribution of Business A to D had "independent significance" under section 351 from the following distribution of the stock of C to P even though the contribution may have been made to remedy D's lack of a trade or business for section 355 purposes. The IRS reasoned that the contribution to D is precisely the sort of transaction section 351 was meant to protect. Further, the IRS noted section

355(b)(2)(C) and (D) themselves allow trades or businesses acquired in tax-free transactions to qualify under 355(b)(1)(A), whereas trades or businesses acquired in taxable transactions would not. Finally, the IRS reiterated that the purpose of the reorganization provisions of the Code is to defer taxing the reshuffling of assets which remain in corporate solution and otherwise satisfy the relevant reorganization provisions of the Code and that respecting the contribution and distribution as distinct transactions is more consistent with that intent.

In the second set of transactions ("Situation 2"), C and D each directly operate a distinct trade or business. Pursuant to a plan of reorganization, C distributes $15X cash and other property worth $10X to D and D contributes appreciated property worth $100X with a basis of $20X to C. D then distributes all of the stock of C to P in a transaction qualifying as a divisive section 368(a)(1)(D) reorganization with a section 355 distribution. The Revenue Ruling addresses whether the distribution by C to D prior to the section 355 distribution should be respected as separate and discrete from the overall reorganization, and therefore taxed under section 301, or whether the distribution and the spin-off ought to be integrated, with distribution of cash and property by C to D more properly being treated as boot received by D in the reorganization.

Here, the IRS held that the distribution by C to D is boot, and that D must recognize gain on the contribution of the appreciated property to C to the extent of that boot. Specifically, D must recognize $25X of the $80X gain realized. In coming to that conclusion, the IRS states that section 361 generally attracts any transfer of money or other property made in pursuance of the plan of reorganization or in connection with the reorganization. Thus, following *Estates of Bell v. Comm'r*, T.C.M. 1971-285, the IRS notes that the boot rules are also the exclusive means of determining whether cash or other property distributed to shareholders incident to a reorganization is a dividend. Speaking directly to that point, the IRS invoked one of its earlier rulings, Rev. Rul. 71-364, which held that unless the facts and circumstances show that a distribution of cash or other property is in substance a separate transaction, section 361(b) demands that the distribution be treated as boot. Therefore, since the distribution by C to D was explicitly made in pursuance of the plan of reorganization, it is boot and not a distribution subject to section 301. A key takeaway from this holding is that, going forward, the scope of what is included in a "plan" may be an area of focus for taxpayers when considering the application of the step transaction doctrine.

No-Rule List

The Revenue Ruling also removes north-south issues from the "no-rule" list found in Rev. Proc. 2017-3. Along with issues involving recapitalizations into control (Rev. Proc. 2016-40) and security-for-debt in leveraged spinoffs (Rev. Proc. 2017-38), the IRS has walked-back the additions to the no-ruling list on section 355 transactions it added in Rev. Proc. 2013-3. More than that, with respect to potential north-south transactions, the Revenue Ruling goes further and gives guidance to taxpayers seeking a private letter ruling, particularly where a given taxpayer's facts resemble the Revenue Ruling.

Recent M&A Guidance

The IRS has also released recent guidance in the M&A area. On March 31, 2017, the IRS Office of Chief Counsel released a legal memorandum (ILM 201713010), addressing whether costs incurred in satisfying a regulatory agency's conditions to approve a merger are required to be capitalized under Treas. Reg. Section 1.263(a)-5 as amounts paid to facilitate a transaction. This legal memorandum considers whether such expenses should be subject to the application of the IRS's approach to capitalization of merger expenses in *Indopco Inc. v. Com.,* 503 U.S. 79 (1992).

In the legal memorandum, the taxpayer is a holding company with regulated subsidiaries. The taxpayer and another company with a regulated subsidiary negotiated a merger. Upon the application to the regulatory board for approval of the merger, the merger was approved subject to four conditions. The four conditions included providing a specified rate credit for each customer of one of the regulated subsidiaries, making a contribution to a customer investment fund, making payments to the state flagged for development of an S, and a making a commitment to contribute Amount T per year to charitable organizations and traditional local community support.

Generally, Treas. Reg. § 1.263(a)-5 requires that a taxpayer must capitalize an amount paid to facilitate certain transactions, including "an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b)." The legal memorandum considers whether the costs of satisfying the regulatory board's four conditions are considered facilitative.

In the memorandum, the IRS explains that it did not have sufficient information to determine whether the taxpayer incurred the costs at issue solely on account of the merger. Notwithstanding, the IRS analysis considered that most of the costs identified are in the nature of annual operating costs that a company would incur as part of its normal business operations. The IRS concluded that the costs at issue appeared to be in the nature of annual operating or investment expenses and not analogous to deal costs paid to service providers who assist with financing, investigating, documenting, or otherwise administratively facilitating the transfer of property. The IRS further concluded that three of the four costs of meeting the regulatory conditions are commonly and frequently required by regulators and are annually incurred by companies as part of their ordinary and recurring business operations.

While the IRS did not reach a conclusion on the facts at issue in the legal memorandum, the legal memorandum provides guidance to taxpayers incurring costs to satisfy conditions set forth by regulatory boards for regulatory approval of a transaction. The legal memorandum suggests that instead of the IRS position in *Indopco* applying to require such costs to be capitalized, such costs should be considered on a cost by cost basis in determining whether they are facilitative deal costs that are required to be capitalized under Treas. Reg. § 1.263(a)-5 or more appropriately ordinary and recurring business operational expenses.

By Sean Tevel and Keith Hagan, Miami

The Second Circuit Agrees with Dissenting Tax Court Judges to Hold the Commissioner Accountable

On March 20, 2017, the Second Circuit ruled on *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part, rev'g in part* T.C. Memo 2015-42, 109 T.C.M. (CCH) 1206. The Second Circuit affirmed the Tax Court's rulings in part, reversed in part, and remanded the case. Most notably, the Second Circuit reversed the portion of the Tax Court's order that had upheld the accuracy-related penalty. Despite the Commissioner's request, the Second Circuit declined to follow the majority opinion in *Graev v. Commissioner*, 147 T.C. 16 (2016). Instead, the Second Circuit conducted its own statutory construction analysis to conclude that the Commissioner failed his burden to prove that he satisfied an element of the accuracy-related penalty claim.

Facts and Procedural Posture

Taxpayer Jason Chai appealed and the Commissioner cross-appealed the Tax Court's order. Chai had underreported his taxable income on his tax return in connection with a $2 million payment that he received for his role in a tax shelter. The Commissioner issued Chai a notice of deficiency for failing to pay self-employment tax on the payment and also asserted a 20-percent accuracy-related penalty. The notice did not assert an income-tax deficiency because the $2 million increase in Chai's income was initially offset for income-tax purposes (but not self-employment tax purposes) by his reported share of a partnership loss. Chai was a member of a partnership ("Mercato") which had reported losses. The loss could be adjusted only in a separate, partnership-level proceeding ("*Mercato* proceeding"). Chai petitioned the Tax Court for redetermination of the self-employment tax.

While the deficiency proceeding was pending, but before the Tax Court determined the proper treatment of the $2 million payment, the partnership losses in the *Mercato* proceeding were disallowed. With that loss disallowed, Chai would owe income tax on the $2 million payment if the Tax Court decided that the payment was income. The Commissioner thus asserted in its amended answer in Chai's personal deficiency proceeding an income-tax deficiency attributable to the $2 million payment. Chai raised for the first time in post-trial briefing that the Commissioner in asserting the penalty failed to carry his burden to show compliance with a written supervisory approval requirement imposed by statute. Chai was represented by the same law firm as the taxpayers in *Graev*.

The Tax Court sustained the self-employment tax deficiency and related penalty. In upholding the penalty assessment, the Tax Court rejected as untimely Chai's argument that the Commissioner failed his burden of production. The Tax Court also dismissed for lack of jurisdiction the Commissioner's later-asserted income-tax deficiency. The Tax Court stated that it lacked jurisdiction over the added income-tax deficiency because Code Section 6230 required the Commissioner to apply the results of the *Mercato* proceeding to Chai by computational adjustment, rather than in his deficiency proceeding.

Chai challenged the ruling upholding his self-employment tax deficiency and the Tax Court's refusal to consider his post-trial challenge with respect to the penalty. The Commissioner challenged the Tax Court's jurisdictional ruling with respect to the income-tax deficiency. Neither party disputed that Chai had $2 million of net income on which he had not paid income tax.

Tax Court's Jurisdictional Ruling was Incorrect

First, the Second Circuit vacated the Tax Court's jurisdictional ruling. The issue was whether the Tax Court had jurisdiction to consider the redetermination of Chai's partnership losses in deciding his income-tax liability resulting from his receipt of the $2 million payment—a payment that had nothing to do with Chai's partnership interest in Mercato. *Chai* did not fit neatly into the statutory methods marrying the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and deficiency proceedings, but procedural oddities did not mean that the tax was uncollectible.

Generally, under TEFRA, the tax treatment of any partnership item and the applicability of any penalty was determined at the partnership level. Once a partnership-level tax proceeding became final, the IRS applied the results to each partner's personal return and calculated any deficiencies. If the deficiency calculation was purely computational, the IRS issued the partner a notice of computational adjustment, not a notice of deficiency. Deficiency procedures moreover did not apply to the assessment or collection of computational adjustments but did apply to an "affected item" per section 6230(a)(2)(A). In cases involving affected items, the IRS was required to issue an affected-item notice of deficiency.

A partnership's net loss could eliminate some of the partner's personal tax deficiencies (but not others, such as a self-employment-tax deficiency), and the non-TEFRA adjustments could wind up being uncollectible because of the expiration of the statute of limitations. *Munro v. Commissioner*, 92 T.C. 71, 74 (1989), resolved the issue by holding that, if a TEFRA proceeding was ongoing, the partnership items included on a taxpayer's return must be ignored in determining a deficiency attributable to non-partnership items. *Munro* created its jurisdictional problems for both the taxpayers and the IRS; thus, Congress created section 6234. Section 6234 provided a declaratory judgment procedure for adjustments to over-sheltered tax returns—returns that showed no taxable income but a net loss from a TEFRA partnership proceeding. In such an instance, the IRS may issue a notice of adjustment for non-partnership items. The taxpayer may challenge the notice in Tax Court, which had jurisdiction to determine the correctness of the adjustment.

The Second Circuit agreed with the Tax Court that neither the increased deficiency attributable to the $2 million payment nor the payment itself was an "affected item." However, the Second Circuit rejected the Tax Court's conclusion that, where section 6230(a)(2) did not apply, the results of the partnership-level proceeding *must* be applied to the taxpayer. Instead, the Second Circuit concluded that a computational adjustment was not the only method that may be employed.

The Second Circuit read neither section 6230 nor any other statutory provision to require the anomalous result of depriving the Tax Court of deficiency jurisdiction in all cases where section 6230(a)(2) did not apply. Here, the IRS used the computational adjustment to apply the results of the *Mercato* proceeding to increase Chai's income. And section 6230 did not require the Tax Court to ignore the effect of that increase on the deficiency computation in the ongoing deficiency proceeding. Rather, the Tax Court had jurisdiction to redetermine the deficiency upon the conclusion of the *Mercato* proceeding. Thus, the Second Circuit held that the Tax Court erred in concluding that it lacked jurisdiction over the additional income-tax deficiency attributable to the $2 million payment. Because Chai conceded that the $2 million payment was fully taxable, it then remanded the case to the Tax Court to enter a revised decision upholding the income-tax deficiency.

The Tax Court's Self-Employment Tax Ruling was Proper

Second, the Second Circuit affirmed the portion of the Tax Court's order upholding the self-employment-tax deficiency. The Second Circuit reviewed the Tax Court's finding as to whether Chai's role in the tax shelter constituted a trade or business. The Second Circuit agreed that the Tax Court did not err in finding that Chai had the requisite profit motive to be engaged in the trade or business and that he engaged in the activity with continuity and regularity. Thus, the Second Circuit held that the Tax Court properly held that the $2 million payment constituted taxable self-employment income.

The Tax Court's Penalty Ruling was Improper

Third, the Second Circuit reversed the portion of the Tax Court's order upholding the accuracy-related penalty. Chai had argued that the Commissioner failed to meet his burden of production under section 7491(c) that he complied with section 6751(b)(1)'s written-approval requirement. Because Chai had raised the issue for the first time post-trial, the Tax Court had declined to consider it.

The Commissioner argued that the Tax Court's decision not to consider Chai's argument was not an abuse of discretion because Chai's argument was too late. However, the Commissioner later shifted its position in its letter to the Second Circuit, urging the court to adopt *Graev*. *See* previous *Tax News and Developments* article, *The IRS Skips Statutory Procedures – The Tax Court Rules in its Favor* (Vol. XVII, Issue 2, March 2017). *Graev* had held that it was premature to argue that the IRS failed to satisfy section 6751(b)(1) until the Tax Court's decision on the penalty became final and the IRS assessed the penalty. In other words, the Commissioner's argument morphed from saying that Chai's argument was too late, to that it was premature.

In order to determine whether the Commissioner failed to meet his burden of production, the Second Circuit had to determine at what time the written-approval obligation attached. The nine judges in the *Graev* majority held that the written approval could be obtained at any time before the penalty was assessed. The five dissenting judges would have held that written approval must be obtained prior to initiating Tax Court proceedings regarding penalties.

The Second Circuit first examined the language of section 6751(b)(1). The court disagreed with the *Graev* majority's view that the statutory language was clear. The provision clearly required written approval of the "initial determination of … assessment" before a penalty could be assessed, but its clarity ended there. The *Graev* majority had concluded that written approval needed to be obtained at some (but not particular) time before assessment. The Second Circuit agreed with the *Graev* dissent that the phrase "initial determination of such assessment" in section 6751(b)(1) was ambiguous because one could not "determine" an "assessment." The Second Circuit therefore consulted legislative history and other tools of statutory construction.

The Senate Finance Committee had stated clearly that the purpose of section 6751(b) was to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. The history "strongly" rebutted the *Graev* majority's view that written approval may be accomplished at any time prior to, even if just before, assessment. The Second Circuit agreed with the *Graev* dissent that allowing an unapproved initial determination of the penalty to proceed through administrative proceedings, settlement negotiations, and Tax Court proceedings, only to be approved afterwards, would do nothing to stem the abuses that section 6751(b)(1) was meant to prevent.

The Second Circuit criticized the *Graev* majority for giving no weight to the IRS's Internal Revenue Manual (the *Graev* majority had called such guidance "salutary" and "immaterial" to its conclusion). The IRS's current administrative practice required a supervisor's approval to be noted on the form reflecting the examining agent's penalty determination or otherwise be documented in the applicable workpapers. Although the IRS's internal guidance was not legally binding, the Second Circuit viewed it as persuasive authority that the IRS read section 6751 to require supervisory approval prior to issuing a notice of deficiency.

The Second Circuit went on to hold that supervisory approval must be obtained no later than the date that the IRS issued the notice of deficiency (or filed an answer or amended answer) asserting the penalty. Supervisory approval must be obtained at least before the Tax Court's decision became final because the discretion to approve or disapprove would be meaningless afterwards. Moreover, for the supervisor's discretion to be given force, the approval must be issued before the Tax Court proceeding was even initiated. Because a taxpayer could file suit at any time after receiving a notice of deficiency, the truly consequential moment of approval was when the IRS issued the notice.

The Second Circuit further held that compliance with section 6751(b) was part of the Commissioner's burden of production and proof in a deficiency case in which he asserted a penalty. Under section 7491(c), "the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty …." Further, Congress was clear that "the Secretary must come forward initially with evidence regarding the appropriateness of applying a particular penalty …." Reading sections 7491(c) and 6751(b)(1) together, the Second Circuit viewed the written-approval requirement as "an element of a penalty claim, and therefore part of the IRS's *prima facie* penalty case."

Given that written approval was an element of a penalty claim and therefore the Commissioner's burden of production, Chai's post-trial argument was "tantamount" to a post-trial motion for judgment as a matter of law. Such challenges were properly (if not necessarily) made post-trial. The Tax Court was obligated to consider the issue of whether the Commissioner had met his burden. It was clear that there was insufficient evidence of compliance with section 6751. Thus, the Second Circuit found that the Commissioner failed to meet his burden of proving compliance with section 6751, a prerequisite to assessment of the accuracy-related penalty. The Second Circuit reversed the portion of the Tax Court's order upholding the penalty assessment.

The Second Circuit determined that the results of a partnership proceeding may be collected through ordinary deficiency proceedings, in addition to the use of the notice of computational adjustments. The Second Circuit allowed the IRS to amend its answer to assert the increased deficiency due to the results of the partnership proceeding.

Moreover, the Second Circuit took a pragmatic approach to interpreting section 6751. The court sided with the *Graev* dissent to hold that the burden was on the Commissioner to show that the penalty was appropriate, and one of the requirements of meeting that burden was to comply with the supervisory written-approval procedures. This case is a win for taxpayers who seek to challenge penalties on similar grounds and a reminder not to discount the importance of procedural defenses.

***By Robert S. Walton,* Chicago and *Yea-Jin Angela Chang,* Palo Alto**

Tax Court Concludes Extensions of Variable Prepaid Forward Contracts are Not Sales or Exchanges

On April 19, 2017, the Tax Court, in a case of first impression, rejected the IRS's position in its dispute with the estate of Andrew J. McKelvey regarding the open transaction doctrine. *McKelvey, Estate of Andrew J. et al. v. Commissioner*, 148 T.C. No. 13 (Apr. 19, 2017). The primary issue was whether extensions to variable prepaid forward contracts (VPFCs) resulted in taxable sales or exchanges. The Court determined: (1) the VPFC extensions did not constitute sales or exchanges under Code Section 1001; (2) the open transaction treatment afforded to the original VPFCs under Rev. Rul. 2003-7, 2003-1 C.B. 363, continued until the transactions were closed by the future delivery of stock; and (3) the VPFC extensions did not constitute constructive sales of stock under Code Section 1259.

Summary of Findings of Fact

Andrew McKelvey was the founder and chief executive officer of Monster Worldwide Inc. ("Monster"), a company known for its website, monster.com.

Effective September 11, 2007, McKelvey entered into a (VPFC) with Bank of America, N.A. ("BofA"), for 1,765,188 shares of Monster class B common stock owned by McKelvey. Per the terms of this VPFC McKelvey received from BofA a cash prepayment of $50,943,578.31 on September 14, 2007. In exchange, McKelvey agreed to deliver to BofA, over the course of 10 separate settlement dates in September 2008, up to 1,765,188 Monster shares or the cash equivalent. The actual number of Monster shares (or the cash equivalent) required for delivery on each settlement date would vary according to the stock market closing price of Monster shares on each specified settlement date. McKelvey could elect to settle the VPFC by delivering the requisite number of Monster shares or the cash equivalent.

Effective September 24, 2007, McKelvey entered into a (VPFC) with Morgan Stanley & Co. International plc (MSI), for 4,762,000 shares of Monster common stock owned by McKelvey. Per the terms of this VPFC, McKelvey received from MSI a cash prepayment of $142,626,185.80 on September 27, 2007. In exchange, McKelvey agreed to deliver to MSI, on or about September 24, 2008, up to 4,762,000 Monster shares or the cash equivalent. The actual number of Monster shares (or the cash equivalent) required for delivery on each settlement date would vary according to the average closing price of Monster shares on specified dates. McKelvey could elect to settle the MSI VPFC by delivering the requisite number of Monster shares or by paying the cash equivalent.

McKelvey treated the execution of the original VPFCs as open transactions under Rev. Rul. 2003-7 and did not report any gain or loss for 2007.

On July 15, 2008, McKelvey paid MSI $8,190,640 in additional consideration to extend the MSI VPFC settlement dates.

On July 24, 2008, McKelvey paid BofA $3,477,949.92 in additional consideration to extend the BofA VPFC settlement dates.

McKelvey died on November 27, 2008, after the execution of the VPFC extensions. Following McKelvey's death, his estate settled (1) the BofA VPFC by delivering to BofA 1,757,016 shares of Monster stock on or about May 8, 2009, and (2) the MSI VPFC by delivering to MSI 4,762,000 shares of Monster stock on or about August 5, 2009.

Issues Presented

The Court had to decide what tax consequences, if any, occurred when McKelvey extended the settlement dates of the original VPFCs on July 15 and 24, 2008.

The Parties' Positions

The IRS determined that the extensions to the original VPFCs resulted in taxable exchanges of the original VPFCs for the MSI and BofA extensions under section 1001, and the extensions to the original VPFCs resulted in constructive sales of the underlying shares of Monster stock under section 1259.

McKelvey's estate contends that the extensions to the original VPFCs merely postponed the settlement and averaging dates of the contracts, did not trigger any tax consequences to McKelvey, and that the open transaction treatment provided by Rev. Rul. 2003-7 continued until the contracts were settled by the future delivery of stock.

Tax Court's Opinion

Section 1001 Sale or Exchange Treatment

The Court determined that the VPFC extensions did not constitute sales or exchanges of property under section 1001.

Treas. Reg. § 1.1001-1(a) provides that an exchange is not a taxable event under section 1001 unless the exchanged properties "differ… materially either in kind or in extent". Accordingly, the Court stated that in order for McKelvey's VPFC amendments to trigger realization of gain or loss, the original VPFCs must constitute property to McKelvey at the time of the extensions and such property must be exchanged for other property differing materially either in kind or in extent.

The IRS argued that the original VPFCs did constitute property because McKelvey possessed three valuable rights in the original VPFCs: (1) the right to the cash prepayments; (2) the right to determine how the VPFCs would be settled (i.e., whether with stock or in cash and if stock, which specific shares); and (3) the right to substitute other collateral. The Court disagreed with the IRS, and instead concluded that McKelvey had only obligations under the contracts and noted that obligations are not property— and, therefore, the VPFCs were not property under section 1001, and section 1001 was inapplicable. The Court concluded that once McKelvey received the cash prepayments owed him on September 14 and 27, 2007, he was left only with obligations to deliver under the terms of the VPFCs and retained no further property rights under the VPFCs, but only obligations that might increase or decrease in amount. The Court also concluded that the contractual provisions allowing McKelvey to choose settlement with stock or in cash and to substitute collateral were not property rights, but rather "procedural mechanisms" designed to facilitate McKelvey's delivery obligations. The Court concluded that these provisions had no value that McKelvey could dispose of in an arm's-length transaction and any "right" exercisable under these provisions was subject to the approval of BofA or MSI. Accordingly, the VPFCs were not property under section 1001, and thus the VPFC extensions did not constitute sales or exchanges of property under section 1001.

Open Transaction Treatment

Next, the Court determined that the open transaction treatment afforded to the original VPFCs under Rev. Rul. 2003-7 continued until the transactions were closed by the future delivery of Monster stock.

To calculate gain or loss realized from a particular transaction, a taxpayer must ascertain both an amount realized and an adjusted basis. Sec. 1001(a); Treas. Reg. § 1.1001-1(a). Certain transactions, such as VPFCs, are afforded "open transaction treatment" because either the amount realized or the adjusted basis needed for a section 1001 calculation is not known until contract maturity.

In Rev. Rul. 2003-7, the IRS had recognized that VPFCs are open transactions when executed and do not result in the recognition of gain or loss until future delivery of stock. The Court stated that "[t]he rationale of Rev. Rul. 2003-7 … is straightforward: A taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made. … Both parties agree that when [McKelvey] entered into the original VPFCs in 2007, the contracts satisfied the requirements of Rev. Rul. 2003-7 … and [McKelvey] recognized no current gain or loss."

The Court noted, and both parties agreed, that the original VPFCs warranted open transaction treatment because, while the amount realized (i.e., the cash prepayments) was known at the inception of the contracts, it was uncertain how many shares McKelvey would have to deliver or what stock shares he would use to settle the contracts at maturity, or if he would choose to discharge his delivery obligations in cash instead of stock.

The Court also concluded that the extensions to the original VPFCs did not close the original transactions and the open transaction treatment afforded to the original VPFCs should continue until the VPFCs were settled by delivery of Monster stock on the extended settlement dates. As the Court concluded, "[t]his uncertainty existed with respect to the original VPFCs, and the extensions to the VPFCs did not resolve what property [McKelvey] would deliver at settlement."

Section 1259 Constructive Sale

Lastly, the Court determined that the execution of the VPFC extensions in 2008 did not trigger constructive sales under section 1259.

Section 1259(c)(1)(C) provides that a taxpayer will be treated as having made a constructive sale if the taxpayer "enters into a future or forward contract to deliver the same or substantially identical property." Section 1259(d)(1) defines a forward contract as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." The Court noted that a forward contract that calls for delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms" is not a forward contract under section 1259 and does not result in a constructive sale of stock.

The Court rejected the IRS's argument that the extended VPFCs should be viewed as separate and comprehensive financial instruments under section 1259 and thus triggered constructive sales under section 1259. The Court concluded that because the open transaction treatment of the original VPFCs continued when McKelvey executed the extensions and, thus, there was no exchange of property under section 1001, the extended VPFCs were not separate and comprehensive financial instruments for purposes of section 1259, and therefore the extensions did not trigger constructive sales.

***By Michael Farrell,* Dallas**

Delaware Disappoints with its Proposed Unclaimed Property Regulations

Last month, Delaware issued proposed regulations for implementing the state's new abandoned and unclaimed property legislation, SB 13. SB 13 was enacted, in part, to address concerns raised in recent litigation, especially those constitutional concerns raised in *Temple-Inland Inc. v. Cook*, 1:14-cv-00654 (D. Del. June 28, 2016) ("*Temple-Inland*"). While many were hopeful that the proposed regulations would provide at least incremental improvement to the state's audit practices, those hopes were largely dashed. Companies currently under audit in Delaware or with potential unclaimed property exposure in Delaware should be advised that the proposed regulations (1) fail to cure important constitutional issues raised in *Temple-Inland* regarding Delaware's practices for estimating a company's historic unclaimed property liabilities, (2) fail to fill in the gaps left by Delaware's new unclaimed property statute, SB 13 (e.g., the proposed regulations provide no guidance on the statutory option to "fast track" an audit), and (3) create new, potential pitfalls for unclaimed property holders.

For more discussion and insight on Delaware's proposed unclaimed property regulations, please see the SALT Savvy blog post from April 21, 2017, *Delaware Issues New Abandoned and Unclaimed Property Regulations*, available at www.saltsavvy.com.

Baker McKenzie
North America Tax

Chicago
+1 312 861 8000

Dallas
+1 214 978 3000

Houston
+1 713 427 5000

Miami
+1 305 789 8900

New York
+1 212 626 4100

Palo Alto
+1 650 856 2400

San Francisco
+1 415 576 3000

Toronto
+1 416 863 1221

Washington, DC
+1 202 452 7000

State Tax Departments Beware, Deference May Be Diminished Under Gorsuch

Several months after the death of Justice Antonin Scalia, Justice Neil Gorsuch has been confirmed as the newest U.S. Supreme Court Justice. Justice Gorsuch will likely be presented the opportunity in the coming terms to help decide cases that will affect several different areas of state tax jurisprudence, including the level of deference that should be afforded to rules promulgated by revenue agencies. Based on his record in the Tenth Circuit, it would not be surprising if, given the chance, Justice Gorsuch were to conclude that the deference standard that currently applies to judicial review of agency regulations is too lenient, and that the power of the administrative state should be curtailed. Under current law, judicial deference to administrative regulations is governed by *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). This seminal case requires a court to defer to reasonable administrative interpretations of ambiguous law—a highly deferential standard that may tip the scales in favor of the state when a court is otherwise required to conduct a *de novo* review of certain agency actions. While *Chevron* only addresses federal regulations, many states either explicitly follow *Chevron* or use deference standards that closely mirror it. However, while serving on the Tenth Circuit, Justice Gorsuch roundly criticized the *Chevron* doctrine and espoused the benefits of a lesser standard of deference. The end of *Chevron* deference at the federal level could have a major impact on the states and state tax departments that currently are given wide latitude to adopt favorable regulations, and it could provide taxpayers with additional arguments against tax department actions that push the boundaries of reasonableness.

For more discussion and insight on the impact of Justice Gorsuch's confirmation on judicial deference to administrative regulations at the state and local level, please see the SALT Savvy blog post from April 24, 2017, *Tax Departments Beware, Deference May Be Diminished Under Gorsuch*, available at www.saltsavvy.com.

Upcoming Washington, DC and San Francisco Conferences Focus on Transfer Pricing in the Midst of Potential US Tax Policy Changes

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

We invite you to join Baker McKenzie and Bloomberg BNA for the Seventh Annual Global Transfer Pricing Conference, to be held June 7-8 at The National Press Club in Washington, DC. The conference will begin with an "Inside Scoop on US Tax Reform," as Senate Finance Committee members from both sides of the aisle, will discuss the prospect of tax reform and how potential policy changes could impact multinational corporations. Government, corporate and private transfer pricing practitioners will continue the conversation throughout the two-day conference, exploring the potential impact and opportunities gained from tax policy changes. Confirmed government speakers include:

www.bakermckenzie.com

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

- **Senate Finance Committee**
  - ***Ryan A. Abraham (D),*** *Senior Tax Counsel*
  - ***Christopher E. Campbell (R),*** *Staff Director*
- **Internal Revenue Service**
  - ***Christopher J. Bello,*** *Chief of Branch 6 - Office of the Associate Chief Counsel (International)*
  - ***Melinda Harvey,*** *Attorney*
  - ***John Hinman,*** *Director - Field Operations Transfer Pricing Practice*
  - ***Tom Kane,*** *Division Counsel - LB&I*
  - ***Deborah Palacheck,*** *Director, Treaty Administration - LB&I*
  - ***Holly Paz,*** *Director - Pass Through Entities Practice Area*
  - ***Nicole Welch,*** *Treaties and EOI IPN Manager - Treaty Assistance and Interpretation Team*
  - ***Nancy Wiltshire,*** *Program Manager - Advance Pricing and Mutual Agreement Program*
- **U.S. Department of Treasury**
  - ***Henry John Louie,*** *Deputy International Tax Counsel - Treaty Affairs, International Tax Policy*
  - ***Robert Stack,*** *Former Deputy Assistant Secretary (International Tax Affairs)*

Agenda and registration details are available at https://www.bna.com/2017-global-transfer-pricing-dc. To receive a reduced rate of $1,095 (regularly $1,395), use Baker McKenzie **corporate guest code BAKDC17** at registration. We hope to see you and your colleagues in Washington, DC!

Save the Date: Baker McKenzie Global Transfer Pricing Workshop – San Francisco – July 28

Baker McKenzie's annual ***Global Transfer Pricing Workshop*** will take place on July 28 at the Palace Hotel in San Francisco. The full day Workshop will focus on the implications of tax reform for transfer pricing, as well as the long-term impacts of the BEPS initiative on corporate operational models in relation to IP and supply chain structures, permanent establishments, value chain analysis, and the valuation of intangibles. The Workshop brings together Baker McKenzie transfer pricing practitioners from around the world to discuss the latest in transfer pricing developments, including APAs and the Multilateral Instrument, transfer pricing audits, and significant legislative changes globally in the wake of BEPS. Additional information, including registration for the Workshop, will be distributed in the coming weeks. To ensure you receive an invitation directly, kindly register your interest at https://goo.gl/Oj1Zsn.

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For further information regarding the North American Tax Practice Group, any of the items or Upcoming Events appearing in this Newsletter, or to receive *Tax News and Developments* directly, please contact Marie Caylor at 312-861-8029 or marie.caylor@bakermckenzie.com.