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In This Issue:

A Side of Tax Reform With Your Thanksgiving Turkey? Congress and the White House Turn to Tax Reform, Promising a Bill in the Fall

IRS Issues Final Regulations that Make it EZ-er to Obtain 501(c)(3) Status

Review of Bilateral Tax Treaties Pending in the Senate

A Web of Confusion - the IRS Issues New Guidance on Section 199 and Online Software

A New Trend in the Market: Sales and Use Tax Obligations Imposed on Marketplace Operators

The Court of Appeals of Iowa Rules an Out-of-State Intangible Holding Company was not doing Business in Iowa

Baker McKenzie Tax Practitioners Visit Minneapolis for September Tax Planning and Transactions Workshop

A Side of Tax Reform With Your Thanksgiving Turkey? Congress and the White House Turn to Tax Reform, Promising a Bill in the Fall

After various attempts to pass a health care bill that would "repeal and replace" the Affordable Care Act, the Senate realized that at this time it did not have 50 votes and agreed to move on in July. Failing to pass a health care bill has both positive and negative impacts for passing tax reform—on the positive side, Congressional Republicans have even more incentive than before to generate a legislative victory going into the midterm elections. But the negative impacts may be more significant—failing to pass health care reform means that passing revenue-neutral tax reform will be more difficult (because Congress intended to use the savings generated by the health care bill to lower the baseline that tax reform needs to meet) and Senate Republicans have not demonstrated an ability to successfully navigate the reconciliation process. Moreover, as they demonstrated during the health care debate, Congressional Republicans are not a monolithic group and, just like health care, there are divisions within the Republican party on tax reform as well.

While members of Congress are spending their August recess trying to generate support from their constituents for tax reform, that doesn't mean they will be able to turn to tax reform immediately upon their return to Washington. There are two significant items that need to be addressed first: (1) raising the debt limit (Secretary Mnuchin estimates that Treasury will run out of "extraordinary measures" sometime in late September, at which point Treasury will not be able to pay all of the government's debts as they come due) and (2) passing a budget by September 30, 2017 (which must include reconciliation instructions if Republicans intend to use the reconciliation process for tax reform). In addition, there are other expiring items, such as the FAA reauthorization bill, that Congress must address by the end of September.

However, progress is being made towards developing a consensus on what should be included in tax reform. For some time now, the "Big Six" (Senators McConnell and Hatch, Speaker Ryan, Chairman Brady, Secretary Mnuchin, and National Economic Council Director Cohn) have been meeting regularly to discuss tax reform.

On July 27, the Big Six released a *statement on tax reform*. The most notable part of the statement was that the Big Six reached an agreement that the border adjustment tax (BAT) will not be part of tax reform. Otherwise, the statement was a high-level and broad show of support for tax reform, but lacked any useful detail, especially about any offsets. According to the statement, "[t]he goal is a plan that reduces tax rates as much as possible, allows unprecedented capital expensing, places a priority on permanence, and creates a system that encourages American companies to bring back jobs and profits trapped

Upcoming Tax Events

Tax Planning and Transactions Workshop

Minneapolis, MN
► September 7, 2017

18th Annual International Tax and Trust Training Program

Coral Gables, FL
► October 19-20, 2017

5th Annual TEI Austin - Baker McKenzie Tax Workshop

Round Rock, TX
► November 9, 2017

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

overseas." Careful readers will note several things about the plan described by the Big Six:

- It doesn't endorse a particular tax rate from among the several different Republican proposals,
- It advocates allowing "unprecedented" capital expensing, which likely reflects the ongoing disagreement between House Republicans (who support full and immediate capital expensing), on the one hand, and Senate Republicans and the Trump Administration, on the other (who don't support full and immediate capital expensing),
- It places a "*priority*" on permanence but doesn't promise permanence, suggesting that there isn't agreement yet among the Big Six about whether tax reform needs to be permanent or whether temporary tax cuts are sufficient,
- It is silent on interest deductibility, and
- It does not explicitly endorse transitioning to a territorial system.

Despite the many open issues, the Big Six announced that tax reform will be moved through "regular order" (meaning that there will be hearings on tax reform and the relevant committees will mark up the legislation) and legislation will move through the Senate Finance and Ways & Means Committees this fall. Some Republicans have suggested that President Trump needs to sign tax reform legislation by Thanksgiving, which is an ambitious goal given how few details have been agreed upon.

While the Big Six work to reach consensus on tax reform, Treasury officials have been busily following the instructions set forth in Executive Order 13789, which required Treasury to identify regulations finalized in the last year of the Obama administration that impose an undue financial burden on US taxpayers, add undue complexity to the Federal tax laws, or exceed statutory authority. See prior *Tax News and Developments* article, *Do Recent Administrative and Legislative Actions Clear a Path for Tax Reform?* (Vol. XVII, Issue 4, May 2017) available under Insight at www.bakermckenzie.com. On July 7, Treasury released Notice 2017-38, which listed eight regulations that Treasury determined were significant and met the criteria listed in the Executive Order. In the Notice, Treasury noted generally that the regulations identified "meet at least one of the first two criteria specified by Section 2 of Executive Order 13789," suggesting that Treasury did not identify any regulations that it believes exceeded the IRS's statutory authority. Notice 2017-38 lists the following guidance projects:

- Proposed regulations under section 103 on definition of "political subdivision,"
- Temporary regulations under section 337(d) on certain transfers of property to RICs and REITs,
- Final regulations under section 7602 on the participation of a person described in section 6103(n) in a summons interview,
- Proposed regulations under section 2704 on restrictions on liquidation of an interest for estate, gift and generation-skipping transfer taxes,
- Temporary regulations under section 752 on liabilities recognized as recourse partnership liabilities,

- Final and temporary regulations under section 385 on the treatment of certain interests in corporations as stock or indebtedness,
- Final regulations under section 987 on income and currency gain or loss with respect to a section 987 Qualified Business Unit, and
- Final regulations under section 367 on the treatment of certain transfers of property to foreign corporations.

Notice 2017-38 requests comments (by August 7) as to whether the regulations should be rescinded or modified and, if the regulations are modified, how they should be modified to reduce burdens and complexity. Pursuant to the Executive Order, Treasury is required to submit a final report to the President on September 18 that recommends “specific actions to mitigate the burden imposed by regulations” listed in Notice 2017-38.

Many taxpayers were pleased to see that the section 385 final and temporary regulations were included in Notice 2017-38, but tax directors may want to manage expectations internally—Treasury has been forthright in letting the public know that Notice 2017-38 is not a list of regulations that Treasury simply intends to rescind. Rather, it seems likely that Treasury is more interested in lessening the burdens imposed by some of these regulations rather than rescinding the listed regulations in their entirety. The issuance of Notice 2017-36, where the IRS announced a one-year delay in the documentation requirements in Treasury Regulations section 1.385-2 (to interests issued or deemed issued on or after January 1, 2019), supports this view.

Readers should stay tuned when Congress returns from its August recess, as there may be a flurry of Committee hearings and drafting activity on tax reform. Offering prompt feedback on the real-world impact of the legislative proposals that are introduced will be invaluable to Congress. At the same time, readers should not lose sight of Treasury’s actions—the Treasury Department is clearly continuing to move forward with the rulemaking process while Congress works on tax reform. Executive Order 13789 and the Administration’s general deregulatory approach provides taxpayers with a unique opportunity to advocate for simpler, less burdensome regulations.

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

IRS Issues Final Regulations that Make it EZ-er to Obtain 501(c)(3) Status

A Code Section 501(c)(3) tax-exempt organization is a corporation, community chest, fund, or foundation organized and operated exclusively (i) for religious, charitable, scientific, public safety, literary, or educational purposes, (ii) to foster national or international amateur sports competition, or (iii) for the prevention of cruelty to children or animals, provided that no part of the net earnings of such entity insure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda or influencing legislation, and the organization does not participate or intervene in any political campaign.

In order for an organization to qualify for tax-exempt status under section 501(c)(3), an organization that is not otherwise exempt from such requirement (e.g., churches, and any organization that is not a private foundation and has gross receipts that do not normally exceed $5,000 per taxable year) must notify

the Secretary of the Treasury of its intent to obtain such status in the manner specified in Treasury Regulations. Section 508(a). Prior to July 2014, an organization notified the Secretary of the Treasury of its desire to obtain section 501(c)(3) status on a properly completed and executed Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code." Treas. Reg. § 1.508-1(a)(2). As part of the application, the organization was required to submit a detailed statement of its proposed activities. Treas. Reg. §§ 1.501(a)-1(b)(1)(iii), 1.501(c)(3)-1(b)(1)(v).

July 2014 Proposed Regulations

The IRS examined the process for satisfying the section 508 notice requirement and determined that the notice requirement could be made more efficient for certain small organizations. Therefore, on July 2, 2014, the IRS released final and temporary regulations that authorized the Commissioner to adopt a streamlined application process for small, eligible organizations to apply for recognition of tax-exempt status. T.D. 9819 (June 30, 2017). Under the temporary regulations, organizations with $50,000 or less in annual gross receipts in the past three years (and projected gross receipts of not more than $50,000 in the current tax year and the next two tax years) and less than $250,000 in assets were permitted to complete a streamlined application on Form 1023-EZ, "Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code." Form 1023-EZ was intended to be a simplified application that would permit eligible organizations to more easily satisfy the notice requirements under section 508, as this form relied heavily on attestations by the organization that it met the section 501(c)(3) requirements. TD 9819 (June 30, 2017). Rev. Proc. 2014-40 included a list of organizations that are not eligible organizations and that are thus required to use the lengthier and more complex Form 1023 to apply for recognition of exemption under section 501(c)(3), and this list included, but was not limited to, foreign entities, churches, schools, colleges, universities, hospitals, private operating foundations, and entities that are not corporations, unincorporated associations, or trusts. Rev. Proc. 2014-40, 2014-30 IRB 229. Organizations were required to submit Form 1023-EZ online at www.pay.gov, as paper submissions were not accepted.

June 2017 Final Regulations

On June 30, 2017, the IRS adopted the proposed regulations that cross-referenced the text of the temporary regulations that permitted eligible organizations to use a streamlined process to apply for tax-exempt status under section 501(c)(3) by submitting Form 1023-EZ. Specifically, Treas. Reg. §§ 1.501(a)-1 and 1.501(c)(3)-1 were amended to authorize the IRS to modify, by regulations or other guidance, the requirement that an organization applying for tax-exempt status must submit a detailed statement of its proposed activities. Going forward, the IRS will continue to study whether applicants should be required to submit a statement in order to satisfy the notice requirements under section 508 and may choose to forego this requirement to further simplify the procedure. T.D. 9819 (June 30, 2017). Additionally, the IRS amended Treas. Reg. § 1.508-1 to specify that eligible organizations are permitted to use Form 1023-EZ (as opposed to the lengthier Form 1023) to notify the Secretary of the Treasury of their intent to obtain tax-exempt status under section 501(c)(3). Thus, the current regulations under Treas. Reg. § 1.508-1(a)(2)(i) state that "an organization seeking exemption under section 501(c)(3) must file the notice described in section 508(a) within 15 months from the end of the month in which

the organization was organized. Such notice is filed by submitting a properly completed and executed Form 1023 (or, if applicable, Form 1023-EZ) exemption application."

In finalizing these regulations, the IRS explained that "[t]he streamlined application process generally allows eligible small organizations to receive IRS determinations of tax-exempt status more quickly and allows the IRS to focus resources on more complex exemption applications and on compliance programs." TD 9819 (June 30, 2017). These regulations are effective on June 30, 2017 but apply after June 30, 2014.

Rev. Proc. 2017-5

Rev. Proc. 2017-5 and the instructions to Form 1023-EZ contain the current instructions for Form 1023-EZ and state that an eligible entity may, but is not required, to use Form 1023-EZ to seek tax-exempt status under section 501(c)(3), as an organization can instead choose to submit Form 1023. Rev. Proc. 2017-5 continues to specify that an organization is not considered an eligible entity unless it has projected annual gross receipts of $50,000 or less in the current taxable year and the next two years, had annual gross receipts of $50,000 or less in each of the past three years, and has assets with a fair market value that does not exceed $250,000. Additionally, the same organizations that were ineligible to submit Form 1023-EZ under Rev. Proc. 2014-40 remain listed in Rev. Proc. 2017-5, and two additional organizations are now also ineligible: agricultural research organizations; and organizations that are currently or were previously exempt under another subsection of section 501(c).

In order for Form 1023-EZ to be considered complete, it must (i) include responses for each required line item, including an accurate date of organization and an attestation that the organization has completed the eligibility worksheet for Form 1023-EZ, (ii) include the organization's correct employer identification number ("EIN"), (iii) be electronically signed, under penalties of perjury, by an individual authorized to sign on behalf of the organization, and (iv) be accompanied by the correct fee. If the organization's name and EIN do not match IRS records, the form will not be considered complete. Form 1023-EZ is still required to be filed electronically by visiting www.pay.gov.

By Ashleigh Hebert, New York

Review of Bilateral Tax Treaties Pending in the Senate

The US Senate has the responsibility of ratifying approved treaties under Article II of the Constitution, yet no new double tax treaties or protocols thereto (interchangeably, "tax agreements") or tax-focused multilateral agreements have been approved through this process since the end of 2009. There are currently eight bilateral tax agreements awaiting Senate approval:

Country	Type	Date Referred to Senate
Hungary	New Treaty (to replace 1979 Treaty)	November 15, 2010
Luxembourg	Protocol	November 15, 2010
Switzerland	Protocol	January 26, 2011
Chile	New Treaty	May 17, 2012
Spain	Protocol	May 7, 2014
Poland	New Treaty (to replace 1974 Treaty)	May 20, 2014
Japan	Protocol	April 13, 2015
Vietnam	New Treaty	Signed July 7, 2015; not yet referred to Senate.

Tax treaties have relief of double-taxation as one of their principal purposes and generally are beneficial to taxpayers qualifying for treaty benefits because they limit the circumstances in which a tax jurisdiction (e.g., Switzerland) can impose tax on income earned by a beneficiary resident in the counterparty jurisdiction (e.g., the US), and also limit the rate of tax that may be imposed on some categories of income. They also provide mechanisms for resolving disputes regarding the application of the treaty and for intergovernmental exchange of tax-related information. Because of the advantages provided to treaty beneficiaries, most tax treaties also have anti-abuse provisions intended to limit access to treaty benefits. The following describes some of the changes contained in the pending tax agreements, including in comparison to the 2006 and 2016 US Model Treaties.

US Model Treaties

US Model Treaties reflect the then-current US tax treaty policy and serve as a starting point in the negotiation of bilateral income tax treaties. The most relevant provisions of the US Model Treaties are summarized below.

Withholding Taxes	2006 Model Treaty Rate Cap	2016 Model Treaty Rate Cap
Dividends with ownership threshold	5% if at least 10% ownership in payor company	5% if beneficial owner is a resident of the other contracting state or a qualifying third state and meets 10% ownership threshold for 12-month period
Dividends without ownership threshold	15%	Same
Interest	0%, with anti-abuse rules	Same; expanded anti-abuse rules.
Royalty	0%, with anti-abuse rules	Same; expanded anti-abuse rules
"Other Income" article*	0%, except for business profits of a PE	0%, unless certain guarantee fee or PE

* Addressing the treatment of income not covered specifically by any other article

Dividends. Under both the 2006 and 2016 Model Treaties, dividends paid by regulated investment companies ("RICs") and real estate investment trusts ("REITs") that are residents of the United States are subject to special rules and are afforded more limited withholding relief, and dividends paid to pension funds enjoy a 0% rate.

Interest and Royalties. The 2006 and 2016 Model Treaties carve out anti-abuse exceptions for several classes of interest including contingent interest payments and an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit ("REMIC"). The 2016 Model Treaty provides additional anti-abuse rules on special tax regimes, notional interest deductions and expatriated entities.

Limitation on Benefits ("LOB"). LOB provisions set out certain categories of residents that are qualified to receive the full benefits afforded by the treaty. Under the 2016 Model Treaty, such qualified residents include (i) public companies and their subsidiaries and (ii) entities that meet both an "ownership test" and a "base-erosion test." Even if a resident does not qualify for full tax benefits, it may nonetheless qualify for limited treaty benefits with respect to specific items of income under the test for so-called "headquarters companies," the active conduct of trade or business rule, or the derivative benefits rule, or through a discretionary ruling by the source state's competent authority ("CA").

Mutual Agreement Procedure ("MAP"). The 2006 Model Treaty provides for a MAP, through which a taxpayer subject to taxation not in accordance with the treaty may present its case to the CA of the contracting state of which it is a resident. If the CA believes the case is justified and cannot resolve the case unilaterally, it must try to resolve the case with the other contracting state through the MAP. The 2016 Model Treaty updates the MAP article by incorporating mandatory binding arbitration for certain cases on which the CAs have been unable to reach a negotiated agreement after a reasonable time period.

Exchange of Information ("EOI") and Administrative Assistance. The 2006 Model Treaty allows the two tax authorities to exchange such information "as may be relevant" in carrying out the provisions of the tax treaty or the domestic laws of either contracting state concerning taxes subject to the treaty. The 2016 Model Treaty modifies the EOI article by limiting its scope to the exchange of information that is "foreseeably relevant." Under both the 2006 and 2016 Model Treaties, a request for information cannot be declined solely because it pertains to information that the requested state does not need for purposes of administering its own tax laws or solely because the information would otherwise be protected by domestic bank secrecy laws. Permissible requests for exchange may include information relating to the assessment or enforcement of—including the collection of, prosecution in respect of, or the determination of appeals in relation to—taxes of any kind.

Hungary

The Proposed Hungary Treaty would modernize the current Hungary Treaty (which was signed when Hungary was still a part of the Soviet bloc) primarily by reducing the withholding rates for certain dividends and introducing robust LOB and EOI articles. The Proposed Hungary Treaty provides for withholding tax rules substantially similar to those in the 2016 Model Treaty.

Withholding taxes	Existing Hungary Treaty	Proposed Hungary Treaty
Dividends with ownership threshold	5% if at least 10% ownership in payor	Same, except 0% for dividends received by certain pension funds and denial of 5% rate for certain RICs and REITs
Dividends without ownership threshold	15%	Same
Interest	0%	Same, except 15% for trade receivables and contingent interest; full for real estate mortgage investment conduits
Royalty	0%	Same
"Other Income" article	0%	Same, unless PE

LOB. The current Hungary Treaty does not have any LOB provisions. The Proposed Hungary Treaty would include LOB rules substantially similar to those included in the 2006 Model Treaty, but with the addition of derivative benefits and headquarters company provisions. In addition, the Proposed Hungary Treaty would preclude treaty benefits for certain triangular arrangements involving PEs in low-tax jurisdictions.

EOI and Administrative Assistance. The current Hungary Treaty's EOI provision is relatively basic and does not touch on, e.g., banking secrecy restrictions. The EOI provision in the Proposed Hungary Treaty is generally similar to the corresponding article in the 2016 Model Treaty, but that the Proposed Hungary Treaty does not provide any mechanism for making information available for other purposes allowed under a US-Hungary mutual legal assistance treaty, among other differences.

Luxembourg

The Luxembourg Protocol would make substantive changes in only one area: the EOI article (Article 26). Under the existing treaty, information sharing is limited to "such information as is necessary." The updated EOI provision would broaden the scope of information sharing by allowing for the exchange of such information "as is foreseeably relevant" in carrying out the provisions of the tax treaty or the domestic laws of either treaty country concerning taxes subject to the treaty. The Luxembourg Protocol also confirms that a State may not refuse to obtain and provide requested information on the grounds that it has no domestic need for the information or that bank secrecy prevents its disclosure. While the Luxembourg Protocol's proposed EOI article is generally comparable to that of the 2016 Model Treaty, the Luxembourg Protocol does not provide any mechanism for making information available for other purposes allowed under a US-Luxembourg mutual legal assistance treaty.

Switzerland

The 2009 Swiss Protocol proposes to amend provisions in the existing Swiss Tax Treaty that relate to dividends (Article 10), MAP (Article 25), and EOI (Article 26).

Withholding Taxes	Swiss Treaty	Swiss Protocol
Dividends with ownership threshold	5% if at least 10% ownership in payor company; 0% for dividends paid to certain retirement plans	Same, except expanded exemption for dividends paid to individual retirement plans
Dividends without ownership threshold	15%	Same
Interest	0%	Same
Royalty	0%	Same
"Other Income" article	0%, except for business profits of a PE and gambling winnings	Same

MAP. The current Swiss Tax Treaty provides for MAP requests, including optional arbitration if the CAs are not able to resolve a dispute. The Swiss Protocol would incorporate mandatory binding arbitration, similar to the 2016 Model Treaty.

EOI. Perhaps the most publicized aspect of the 2009 Swiss Protocol is the expanded EOI provision. Under the current Swiss Treaty, information sharing is limited to sharing "as is necessary" for carrying out the treaty or "for the prevention of fraud or the like." The Swiss Protocol's EOI provision would allow the two tax authorities to exchange such information "as may be relevant" in carrying out the provisions of the tax treaty or the domestic laws of either contracting state concerning taxes subject to the treaty. Not only is the "may be relevant" standard significantly broader than the existing, "as is necessary" standard, it is also broader than the "foreseeably relevant" standard included in the 2016 Model Treaty and proposed in some of the other tax agreements discussed here. Furthermore, the Swiss Protocol would no longer require tax fraud or related fraudulent conduct as a basis for an exchange of information, instead referring to the "enforcement" of domestic laws. Similar to the 2016 Model Treaty, the Swiss Protocol also provides that a State may not refuse to obtain and provide requested information on the grounds that it has no domestic need for the information or that bank secrecy prevents its disclosure.

Chile

The United States currently does not have an income tax treaty with Chile. This treaty would be the second US income tax treaty in South America, after Venezuela. The chart below compares the withholding regimes of the Proposed Chile Treaty and the 2016 Model Treaty.

Withholding taxes	Proposed Chile Treaty	2016 Model Treaty
Dividends with ownership threshold	5% if at least 10% ownership in payor	5% if beneficial owner is a resident of the other contracting state or a qualifying third state and meets 10% ownership threshold for 12-month period
Dividends without ownership threshold	15% generally	Same

Withholding taxes	Proposed Chile Treaty	2016 Model Treaty
Interest	4% if beneficially owned by a resident bank or insurance company of the other country; 10% in all other cases, but 15% for the first 5 years article is in effect	0%, with anti-abuse rules
Royalty	2% for use of industrial, commercial, and scientific equipment; 10% for artistic, literary, and intangible property	0%, with anti-abuse rules
"Other Income" article	0%, unless PE	0%, unless certain guarantee fees or PE

LOB. The Proposed Chile Treaty includes modern LOB rules generally similar to those in the 2006 Model Treaty, although with the addition of a provision for headquarters companies. The Proposed Chile Treaty would include an anti-abuse rule on triangular arrangements similar to that discussed for Hungary, above.

MAP. The Proposed Chile Treaty would provide for MAP requests in a manner generally similar to that of the 2016 Model Treaty, but excluding mandatory, binding arbitration.

EOI. The Proposed Chile Treaty's EOI articles are generally similar to those of the 2016 Model Treaty, except that the Proposed Chile Treaty does not permit the CAs to make information available for other purposes allowed under a US – Chile mutual legal assistance treaty.

Spain

The Spain Protocol would generally reduce withholding rates, as noted in the chart below, and modernize the LOB, MAP, and EOI articles.

Withholding taxes	Spain Treaty	Spain Protocol
Dividends with ownership threshold	10% if at least 25% ownership in payor	5% if at least 10% ownership; 0% if at least 80% ownership and LOB requirements met
Dividends without ownership threshold	15% generally	Same
Interest	10%, except 0% for government loans, financial institution long-term loans, and trade financing	0%, except for contingent interest and an excess inclusion with respect to a residual interest in a REMIC
Royalty	5% for artistic works; 8% for films and industrial/ commercial/ scientific/ works; 10% for others	0%
"Other Income" article	0%, unless real estate or PE	Same

LOB. The Spain Protocol contains an LOB provisions substantially similar to that of the 2006 Model Treaty, with the addition of a derivative benefits and headquarters company provision.

MAP. The Spain Protocol would incorporate MAP provisions similar to the 2016 Model Treaty provisions, including mandatory binding arbitration.

EOI and Administrative Assistance. The existing Spain Treaty uses the "as is necessary" standard for information exchange. The Spain Protocol would have an EOI article in line with the 2016 Model Treaty, including using the "foreseeably relevant" standard and the prohibition on denying requests for exchange of information solely on the basis of domestic bank secrecy laws.'

Poland

The most significant change under the Proposed Poland Treaty is the introduction of an LOB article; the current treaty has none.

Withholding taxes	Existing Poland Treaty	Proposed Poland Treaty
Dividends with ownership threshold	5% if at least 10% ownership in the payor	Same, except for an expanded limitation on source-country taxation of dividends in cases of pension funds, RICs, and REITs
Dividends without ownership threshold	15% generally	Same
Interest	0%	Up to 5% of the gross amount of the interest, with exceptions
Branch Profits	No provision	5% of the portion attributable to the PE in contracting country
Royalty	10%	Up to 5% of the gross amount of the royalties, including equipment rentals (contrary to US Model Treaty policy)
"Other Income" article	No provision	0%, except for business profits of a PE

Interest. Under the Proposed Poland Treaty, the general withholding tax rate on cross-border payments of interest would be increased to 5 percent, with exemptions for interest payments to pension funds, financial institutions, and either of the contracting states or their political subdivisions. Certain contingent interest payments would be subject to a 15 percent withholding rate.

Branch Profits. As noted in the chart, the Proposed Poland Treaty would add a branch profits provision relating to PEs and amounts taxable as real property income or capital gains. The imposition of such tax in the US would be limited to a 5 percent tax on the "dividend equivalent amount," which is consistent with the US domestic rules on the taxation of branch profits. The Proposed Poland Treaty

would also add a branch interest provision applying the same rates as under its interest article (proposed Article 11).

LOB. The Proposed Poland Treaty includes a modern LOB article substantially similar to that of the 2006 Model Treaty, with the addition of a derivative benefits and headquarters company provision. The current Poland Treaty does not provide any LOB rules.

MAP. The Proposed Poland Treaty provides a time limitation (generally three years) for MAP requests and an option for a joint commission of the CAs or their representatives, in the nature of voluntary arbitration.

EOI. The Existing Poland Treaty uses the "as is necessary" standard for information exchange. The Proposed Poland Treaty would have an EOI article in line with the 2016 Model Treaty, including using the "foreseeably relevant" standard and prohibiting bank secrecy or "no domestic use" conditions from preventing information exchanges, except that the Proposed Poland Treaty does not provide any mechanism for making information available for other purposes allowed under a US-Poland mutual legal assistance treaty.

Japan

The Japan Protocol would broaden the exemptions from source-country taxation of dividends and interest, adopt mandatory binding arbitration, and broaden and modernize the rules on EOI.

Withholding taxes	Japan Treaty	Japan Protocol
Dividends with ownership threshold	0% if more than 50% ownership for 12 months and if certain LOB requirements met; 5% if at least 10% ownership	Same, except 0% if at least 50% ownership for 6 months
Dividends without ownership threshold	10%	Same
Interest	10%	0%, but with anti-abuse exceptions
Royalty	0%	Same
"Other Income" article	0%, unless PE or transfer pricing issues	Same

Dividends. The Japan ownership and holding period standards for zero-percent dividend withholding are among the most generous in all US tax treaties.

MAP. The Japan Protocol MAP provisions are substantially similar to the 2016 Model Treaty provisions, including mandatory binding arbitration for disputes that the CAs cannot resolve within two years of the case commencement date.

EOI. The Japan Protocol would broaden and modernize the rules on EOI, going from an "as is relevant" to a "foreseeably relevant" standard for information exchange and generally matching the 2016 Model Treaty provisions. However, confidential communications with legal representatives that are protected by privilege are specifically carved out from the scope of permissible EOI requests.

Vietnam

The United States currently does not have an income tax treaty with Vietnam. The chart below compares the withholding regimes of the Proposed Vietnam Treaty and the 2016 Model Treaty.

Withholding taxes	Proposed Vietnam Treaty	2016 Model Treaty
Dividends with ownership threshold	5% if at least 25% ownership in a US-resident company or at least 25% capital in a Vietnam-resident company	5% if beneficial owner is a resident of the other contracting state or of a qualifying third state and meets 10% ownership threshold for 12-month period
Dividends without ownership threshold	15%	Same
Interest	10%; special rules for contingent interest and REMICs	0%, with anti-abuse rules
Royalty	5% for use of industrial, commercial and scientific equipment; 10% for literary, artistic, scientific work or patents, trademarks, design or model plans, secret formulas or processes	0%, with anti-abuse rules
"Other Income" article	0%, unless PE or independent personal services	0%, unless certain guarantee fee or PE

LOB. The Proposed Vietnam Treaty includes modern LOB rules generally similar to those of the 2006 Model Treaty.

MAP. MAP requests would be permitted under the MAP article in the Proposed Vietnam Treaty when a taxpayer is subject to taxation not in accordance with the treaty, but the MAP rules do not provide for arbitration of unresolved disputes (either voluntary or mandatory).

EOI. The EOI provision in the Proposed Vietnam Treaty is substantially similar to the corresponding provision in the 2016 Model Treaty.

Ratification Outlook

Progress on ratification of these pending tax agreements has been slow, with at least one Senator objecting to the expanded EOI provisions contained in the agreements. Given the various other political items currently facing the Senate, it is not clear whether ratification is likely in the near term. However, many of these agreements could provide significant benefits for US taxpayers investing in or

transacting business with affected jurisdictions—particularly in Chile and Vietnam, where there is not currently a tax treaty in place. We are monitoring the status of these agreements closely and will keep readers updated on further developments.

By Michelle R. Phillips, Christine M. Kim, and Eric M. Biscopink, Washington, DC

A Web of Confusion - the IRS Issues New Guidance on Section 199 and Online Software

On June 16, 2017, the IRS released Chief Counsel Advice ("CCA") 201724026, addressing the applicability of Code Section 199 to taxpayers deriving income from online software. Section 199, otherwise known as the domestic production activities deduction, has been the focus of considerable dispute between taxpayers and the IRS since its introduction in 2005 as part of the American Jobs Creation Act. Historically, the focus of dispute between taxpayers and the IRS has been the benefits and burdens test set forth in the section 199 Treasury Regulations (the "Regulations") as it applies to contract manufacturing arrangements. While this remains an area of contention, the tides of controversy are shifting to a dispute that centers on the availability of the deduction for taxpayers generating revenue through online software. This dispute raises several important questions. In particular, it calls into question whether the Regulations are consistent with the intent of the statute and the changing commercial realities of technology-based companies. Even if the Regulations provide the necessary guidance, the dispute also raises the issue of whether the IRS's interpretation, as described in CCA 201724026, is consistent with the plain language of the Regulations.

Before reviewing the details of CCA 201724026, it is important to understand the statutory and regulatory framework governing section 199 and online software. Beginning with the statute, section 199(a) provides that a taxpayer is entitled to a deduction equal to a percentage of its income derived from the lease, rental, license, sale, exchange or other disposition of qualifying property. Qualifying property includes, among other things, US-developed computer software. Nothing in section 199 delineates between revenue generated from software made available online and revenue generated from software made available through download, tangible medium, or any other means.

Treas. Reg. § 1.199-3(i)(6)(ii) provides that revenue derived from "online services" and "other similar services" do not qualify as revenue derived from the disposition of computer software. There is an exception to this rule, however, for situations where a taxpayer generates revenue from providing customers "access to computer software…for the customers' direct use while connected to the Internet" and either: (1) the taxpayer also generated revenue from providing similar software to customers via download or tangible medium (the "Self-Comparable Exception"); or (2) a competitor of the taxpayer generated revenue from providing similar software to customers via download or tangible medium (the "Competitor Exception"). Treas. Reg. § 1.199-3(i)(6)(iii). Examples 4 and 5 of Treas. Reg. § 1.199-3(i)(6)(v) demonstrate these exceptions:

> *Example 4. O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated*

persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software…O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

Example 5. The facts are the same as in Example 4, except that O does not sell the tax preparation computer software to customers affixed to a compact disc or by download. In addition, one of O's competitors, P, derives, on a regular and ongoing basis in its business, gross receipts from the sale to customers of P's substantially identical tax preparation computer software that has been affixed to a compact disc as well as from the sale to customers of P's substantially identical tax preparation computer software that customers have downloaded from the Internet…O's gross receipts derived from providing access to its tax preparation online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

In CCA 201724026, the IRS considered the statutory and regulatory framework described above in analyzing a claimed section 199 deduction for a taxpayer in the business of selling online access to software enabling platforms such as websites, applications, data centers, hardware, and computer networks. CCA 201724026 includes considerable redactions with respect to taxpayer specific information, so the details surrounding the taxpayer's business and fee structure are unclear. It appears, however, that the taxpayer charged a variety of fees to customers in exchange for online access to its various software platforms. The taxpayer's claimed deduction relied on the Competitor Exception, with the taxpayer citing to evidence of third parties offering similar software via download or tangible medium. The IRS did not take issue with the existence of such competitors. Rather, the IRS argued that the Competitor Exception did not apply because the taxpayer failed to establish that it had generated revenue from providing its customers with "access to the computer software" for their "direct use" while connected to the Internet. The IRS concluded that the taxpayer's revenues were attributable to a service provided by the taxpayer that was simply enabled by the computer software.

CCA 201724026 is not surprising. In fact, it is consistent with the position that audit teams have been taking for years with respect to online software. Further, it is likely a reflection of the IRS's litigation position with respect to several upcoming controversies likely to make their way to the Tax Court. First among those cases is *Vesta Corp. v. Commissioner* (Docket No. 026847-16), where the Competitor Exception is at the center of the dispute.

The author expects that the upcoming litigation in this area will highlight taxpayer concerns regarding the IRS's approach to online software. In particular, the Tax Court will have to grapple with whether the Regulations carry out the intent of the statute. Under the IRS's "direct use" test, it is difficult to envision a scenario short

of a taxpayer granting a customer access to the taxpayer's software code that allows an online software company to qualify for the section 199 deduction. With that sort of standard, the deduction will be lost. In other words, despite Congress's clear intent that taxpayers use section 199 to help spur US job growth, the incentive will disappear when it comes to high-paying software development jobs.

Another shortfall in the IRS's argument is its failure to recognize changes in the technology world. Treasury drafted the Regulations at the heart of this dispute nearly a decade ago. In the tech industry, ten years is the equivalent of three to four lifetimes. Today's tech world relies more and more on cloud-based technologies, not software made available through download or tangible medium. More than ever, the means by which the software is made available is meaningless. In CCA 201724026, the IRS is clear in its view that this distinction matters. Taxpayers headed towards litigation are sure to point out that nothing in the statute supports such an approach. Taxpayers are also likely to argue that such an approach ignores the changing realities of the technology world. The Tax Court will ultimately have to decide whether the Regulations provide a reasonable framework for analyzing online software and section 199.

Finally, even if we put the intent of the statute and realities of the industry aside, the IRS's position is inconsistent with the results of Examples 4 and 5 of Treas. Reg. § 1.199-3(i)(6)(v). In CCA 201724026, the IRS attempts to explain away these examples. Specifically, the IRS argues that the online tax preparation software in Examples 4 and 5 gives rise to qualifying income because the customers use the software for purposes of completing their returns. In contrast, had the customers only used the software to "enter W-2 information" that was used by a tax return preparer to complete the customer's return, the related income would not qualify under section 199 because it would relate to a service. The author does not see how this explanation supports the IRS's position. If anything, this explanation stands for the notion that revenues generated from automated online software should qualify. Where the software is used to support services provided by the taxpayer's employees, there is little dispute that an allocation is appropriate to identify qualifying revenues generated from use of the software and non-qualifying revenues generated from the services of the employee.

So where does CCA 201724026 leave taxpayers? It is safe to say that the IRS will continue to make it difficult for online software companies to claim the section 199 deduction. Until the dust of litigation settles, the environment is unlikely to change. It will be particularly interesting to see whether the Regulations face a challenge under the principles of *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015). Given the language and intent of section 199, such a challenge could be at the core of how this issue ultimately plays out. For more information about *Altera*, see prior *Tax News and Developments* article, *Tax Court Invalidates Treasury Regulation in Altera* (Vol. XV, Issue 4, August 2015) by Duane Webber, Joseph Judkins, and Kristyn Judkins, and available under Insight at www.bakermckenzie.com.

By Jonathan Welbel, Chicago, IL

A New Trend in the Market: Sales and Use Tax Obligations Imposed on Marketplace Operators

In moves that may signal the start of a trend, Minnesota and Washington recently enacted laws that impose sales and use tax obligations on certain marketplace operators who facilitate the sales of out-of-state third party retailers. Similar legislation is also pending in the Pennsylvania General Assembly. The efforts are intended to increase use tax compliance while sidestepping or outright challenging the *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) physical presence requirement.

Minnesota House File 1 expands the definition of “retailer maintaining a place of business in [Minnesota]” to include an out-of-state retailer making Minnesota sales in excess of $10,000 through a marketplace provider that maintains a place of business in Minnesota. Further, it generally requires Minnesota marketplace providers to collect and remit Minnesota sales and use tax on the sales it facilitates on behalf of out-of-state third party retailers.

Washington House Bill 2163 requires out-of-state marketplace facilitators with Washington sales in excess of $10,000 to either register to collect and remit Washington sales tax on behalf of the remote sellers who sell through their marketplace or comply with Washington’s newly-established use tax notice and reporting regime with respect to such sales. Washington’s use tax notice and reporting regime is similar to Colorado’s use tax notice and reporting law that was upheld by the Tenth Circuit Court of Appeals last year.

Similar to the Minnesota and Washington laws, Pennsylvania House Bill 542, which recently passed the Pennsylvania Senate, would require marketplace providers to collect and remit Pennsylvania sales and use tax on behalf of the third party sellers whose retail sales they facilitate regardless of whether the marketplace provider receives a commission or other consideration from such sellers.

For a full discussion of the Minnesota, Washington, and Pennsylvania laws and their potential implications, please see <u>*A New Trend in the Market: Sales and Use Tax Obligations Imposed on Marketplace Operators*</u>, available at <u>www.saltsavvy.com</u>.

The Court of Appeals of Iowa Rules an Out-of-State Intangible Holding Company was not Doing Business in Iowa

The Court of Appeals of Iowa recently held that: (1) a parent holding corporation was ineligible to join its Iowa subsidiaries’ consolidated Iowa income tax returns because the holding company was not subject to Iowa income tax; and (2) the holding company’s Iowa subsidiaries could not deduct certain expenses incurred and paid directly by the holding corporation but ratably allocated to the subsidiaries based on a percentage of revenue approach. The case, *Romantix Holdings Inc. v. the Iowa Dept. of Revenue*, dated May 3, 2017, broadly holds that an in-state operating subsidiary’s use of an out-of-state holding company’s intangible property, including a business trademark, does not necessarily create nexus for the out-of-state holding company with Iowa. The Court’s decision does

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not contain any discussion of whether the in-state subsidiaries compensated the out-of-state holding company for the use of the business trademark in their Iowa business operations. Without this analysis, it is difficult to fully reconcile the holding in *Romantix* with the Iowa Supreme Court's decision in *KFC Corp. v. Iowa Dept. of Revenue*, dated December 30, 2010, where it was held that "Iowa could tax a foreign corporation whose only connections with Iowa were franchise agreements in which it licensed its trademarks and systems to independent franchisees doing business in Iowa."

The taxpayer in *Romantix* argued that the parent holding company could be included in a consolidated Iowa corporate income tax return with its Iowa operating subsidiaries, and thus offset its expenses with its Iowa subsidiaries' revenue, because the parent holding company "directly owned intangible property that was utilized by its subsidiaries in the subsidiaries' Iowa business activity". The Court rejected this argument because Iowa law specifically states that a "foreign entity" is not "doing business" in Iowa and is not "deriving income from sources within [the] state" if that foreign entity owns or controls a subsidiary that is transacting business in Iowa and where such foreign entity otherwise has no physical presence in the state. Applying this rule as the baseline for its analysis, the Court found that the parent holding company was not allowed to join its Iowa subsidiaries in a consolidated Iowa corporate income tax return. The Court also held that, while the Iowa subsidiaries may have supplied money to the parent holding company to pay certain business expenses, the subsidiaries did not actually make the expense payments themselves. As a result, the Iowa subsidiaries were not allowed to deduct from their Iowa taxable revenue the money they transferred to their parent holding company and which the parent directly used to pay its business expenses.

For more discussion and insight on the *Romantix Holdings Inc. v. the Iowa Dept. of Revenue* case, please see the SALT Savvy blog post from July 17, 2017, *The Court of Appeals of Iowa Rules An Out-of-State Intangible Holding Company Was Not Doing Business In Iowa*, available at www.saltsavvy.com.

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Baker McKenzie Tax Practitioners Visit Minneapolis for September Tax Planning and Transactions Workshop

Join Baker McKenzie this September 7 for *Tax Planning for the Remainder of 2017 and Beyond*, a complimentary full-day workshop to be held at the Radisson Blu Minneapolis Downtown. The Workshop will provide updates on US legislative and regulatory issues, discuss key strategies in repatriation planning, and highlight recent developments in international tax. Corporate attendees will also have the opportunity to participate in their choice of three breakout sessions throughout the day on the following topics:

- Current topics regarding mergers and acquisitions
- Final and temporary regulations under Code Section 987
- Supply chain planning in regards to BEPS guidance, Subpart F and Substantial Contribution
- Recent planning strategies with partnerships in Subchapter K
- State and local tax developments
- Tax strategies and issues involving Pre- and Post- Acquisition matters

For full conference details, agenda, and registration information, see the Tax Planning and Transactions event web page, also available at http://www.bakermckenzie.com/tax/events.

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

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