Tax News and Developments
North America Tax Practice Group

Baker McKenzie.

# Newsletter

April 2018 | Volume XVIII, Issue 3

**In This Issue:**

Treasury, OMB Agree to Revise Review Process For Tax Regulations

Three New LB&I Compliance Campaigns for Pass-Through Entities

The Supreme Court Rejects the Government's Attempt to Merely Use "Prosecutorial Discretion" Under the Omnibus Clause

Tax Court Upholds Section 956 Regulations on Guaranties

2017 IRS APMA Annual Report: Some Accomplishments, but Challenges Remain

How China's Withholding Tax Relief Affects Foreign Investors

New York Legislature Passes $168.3 Billion Budget; Includes Comprehensive Response to Federal Tax Reform

Summary Judgment Denied (Again) in District of Columbia Transfer Pricing Cases

Discuss US Tax Reform with Baker McKenzie at upcoming events in New York and Washington, DC

## Treasury, OMB Agree to Revise Review Process For Tax Regulations

On April 11, 2018, Treasury and the Office of Information and Regulatory Affairs ("OIRA") entered into a new Memorandum of Agreement ( the "MOA") setting forth the circumstances under which OIRA (an office within the Office of Management and Budget (the "OMB")) will review tax regulations on a going-forward basis. (Click here for a copy of the MOA.) The MOA replaces an earlier agreement, reached in 1983 and revised in 1993, that largely exempted tax regulations from OMB review. The MOA provides taxpayers with an additional opportunity to engage with the administration during the regulatory process, and taxpayers may find OIRA more sympathetic to some of their concerns about regulatory burden than Treasury and IRS have historically been.

### Overview of the MOA

Under the MOA, OIRA will review tax regulatory actions that are likely to result in a rule that may "(a) create a serious inconsistency or otherwise interfere with an action taken or planned by another agency; (b) raise novel legal or policy issues, such as by prescribing a rule of conduct backed by an assessable payment; or (c) have an annual non-revenue effect on the economy of $100 million or more, measured against a no-action baseline." The scope of tax regulatory actions that are subject to OIRA review under the MOA is similar, but not identical, to the definition of a "significant regulatory action" in Executive Order 12866. Notably, the MOA applies to tax regulatory actions that have "an annual *non-revenue* effect on the economy of $100 million or more," whereas E.O. 12866 defines a significant regulatory action subject to OIRA review more broadly to include actions that "may have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities." As a result, the amount of revenue raised by a tax regulation will not be taken into account when determining whether OIRA will review a regulation, but the amount of compliance costs incurred by taxpayers under the regulation will be taken into account.

Tax regulatory actions that are subject to OIRA review will be subject to the analytical requirements that E.O. 12866 imposes on significant regulatory actions in section 6(a)(3)(B)—namely, Treasury will be required to provide OIRA with

- The text of the draft regulatory action,
- A "reasonably detailed" description of the need for regulatory action,

## Upcoming Tax Events

Doing Business Globally

Mexico City
► April 25, 2018

TEI Audits & Appeals Seminar

New Orleans, LA
► April 30 - May 3, 2018

TEI Software & E-Commerce Day XXII

Redwood City, CA
► May 1, 2018

15th Annual Global Tax Planning and Transactions Workshop

New York, NY
► May 23, 2018

Baker McKenzie and Bloomberg BNA Global Transfer Pricing Conference

Washington, DC
► June 6-7, 2018

*Register with corporate guest code BAKDC18*

- An explanation of how the regulatory action meets the need identified, and
- An assessment of the regulation's potential costs and benefits.

Tax regulatory actions that may have an annual non-revenue effect on the economy of $100 million or more will also be subject to the analytical requirements described in section 6(a)(3)(C) of E.O. 12866, which requires an agency to provide OIRA with:

- An assessment, including the underlying analysis, of the expected benefits of the regulatory action (along with a quantification of those benefits, to the extent feasible),
- An assessment, including the underlying analysis, of the expected costs of the regulatory action (along with a quantification of those benefits, to the extent feasible), and
    - Costs include the direct cost to the government of administering the regulation and to businesses of complying with the regulation, as well as any adverse effects on the efficient functioning of the economy or private markets
- An assessment, including the underlying analysis, of the costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation, and an explanation as to why the planned regulation is preferable to the alternatives identified.

This analysis is generally referred to as a "Regulatory Impact Analysis."

Importantly, the purpose of OIRA's review is to ensure an effective and efficient regulatory process, prevent administrative agencies from issuing regulations that are inconsistent with actions undertaken by other agencies, and ensure that agencies have considered all feasible options. OIRA's responsibilities do not include second-guessing the tax policy decisions made by Treasury.

Under the previous agreement between Treasury and OMB, most tax regulations were exempt from OIRA review (although notable exceptions where OIRA reviewed tax regulations include Circular 230, the consolidated return regulations, and the recent Section 385 regulations). As a result, Treasury does not have much experience with providing the analysis required under sections 6(a)(3)(B) and (C) of E.O. 12866. For an example of a regulation where Treasury has previously provided a Regulatory Impact Analysis, see the section titled, *Regulatory Assessment under E.O. 12866, as Supplemented by E.O. 13563*, in the preamble to Treasury Decision 9527, Regulations Governing Practice Before the Internal Revenue Service (more commonly referred to as "Circular 230").

Treasury and the IRS will need to develop internal procedures to prepare the analysis required by the MOA, and train the staff responsible for conducting the analysis. The MOA acknowledges that Treasury will not be able to conduct the analysis under section 6(a)(3)(C) of E.O. 12866 immediately, and provides that Treasury will be required to begin providing OIRA with a Regulatory Impact Analysis for affected regulations on the earlier of April 11, 2019 (which is twelve months after the date of the agreement) or when Treasury obtains reasonably sufficient resources, with OMB's assistance, to perform the required analyses. Treasury is required to begin providing the economic analysis described in section 6(a)(3)(B) of E.O. 12866 immediately for regulations that are subject to the MOA.

Regulations that are subject to OIRA review under the MOA generally will be reviewed within 45 days (subject to extension upon the mutual agreement of Treasury and OMB). To ensure the timely implementation of the Tax Cuts and Jobs Act of 2017, either the Secretary or the Deputy Secretary of the Treasury may designate specific regulations for expedited review, which must be conducted within 10 days (subject to extension upon the mutual agreement of Treasury and OMB).

## What does the MOA mean for the future of tax regulations?

Although the MOA expands the number of tax regulations that will be subject to OIRA review to bring tax regulations more in line with the level of review imposed on other agency's regulations, the scope of OIRA's review is not as broad as many commentators had feared.

Some commentators were concerned about expanding OIRA's review of tax regulations because OIRA does not have staff with tax expertise, Treasury and IRS do not have much experience preparing the analyses required by E.O. 12866, and subjecting tax regulations to OIRA review could significantly slow down the release of tax guidance. It appears that Treasury and OIRA have attempted to address these concerns in the MOA, although only time will tell whether these efforts are successful.

As a practical matter, in order to successfully implement the MOA, both Treasury and OIRA will likely need to hire additional staff. Also, Treasury and IRS will need to develop procedures and guidelines for preparing the analyses required under the Executive Order, and train their employees accordingly—under the previous agreement, these analyses were prepared so infrequently that most attorneys at IRS went their entire careers without ever drafting a Regulatory Impact Analysis.

In the short term, the expanded scope of OIRA review will almost certainly slow down the issuance of tax regulations, despite efforts in the MOA to provide for expedited review. This impact should be reduced over time, as Treasury and IRS become more familiar with preparing the required analyses and as OIRA develops tax expertise.

Expanding the scope of OIRA's review of tax regulations also provides taxpayers with another opportunity to participate in the regulatory process and potentially influence regulatory content. OIRA may be more sympathetic to taxpayers' concerns about the amount of compliance burdens imposed by tax regulations than Treasury and IRS have been historically. Taxpayers should carefully review the MOA and determine what impact it has on their strategy for regulatory engagement with Treasury, particularly with respect to tax reform.

Ultimately, the increased opportunity for taxpayers to participate in the regulatory process through engaging with OIRA on tax regulations may be the most significant impact of the MOA.

***By: Joshua Odintz and Alexandra Minkovich, Washington, DC***

# Three New LB&I Compliance Campaigns for Pass-Through Entities

On March 13, 2018, the IRS Large Business and International division ("LB&I") announced the identification and selection of five additional compliance campaigns, as part of its move toward issue-based examinations. The initial rollout began on January 31, 2017, with the announcement of 13 campaigns, followed by an additional 11 campaigns announced on November 3, 2017. See prior *Tax News and Developments* article, *IRS's LB&I Division Releases Five New Transfer Pricing Directives* (March 2018).

The campaigns are the culmination of an extensive effort to redefine large business compliance work and build a supportive infrastructure inside LB&I. Each campaign was identified through LB&I data analysis and suggestions from IRS compliance employees. The goal is to improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources.

Of the five most recently announced campaigns, three are in the practice area of pass-through entities. Taxpayers in this practice area should be aware of these campaigns and undertake efforts to avoid falling within their scope.

## Self-Employment Tax

The first campaign is aimed at limited partners and limited liability company ("LLC") members who render services on behalf of the partnership or LLC but do not report flow-through income as earnings from self-employment and, thus, do not pay self-employment tax under the Self-Employment Contributions Act ("SECA") on such income.

Generally, if a partner is an individual who renders services on behalf of a partnership, the partner's distributive share of income is subject to SECA tax. There is an exception under Code Section 1402(a)(13), which excludes from the definition of "net earnings from self-employment" the distributive share of any item of income or loss of a *limited partner*, as such, other than certain guaranteed payments. However, the exception has been interpreted narrowly under case law. For example, in *Renkemeyer, Campbell & Weaver, LLP, et al. v. Commissioner*, 136 T.C. 137 (2011), the Tax Court held that attorney-partners of a law firm set up as a limited liability partnership ("LLP") were not limited partners for purposes of Section 1402(a)(13) because the distributive shares received "arose from legal services they performed on behalf of the law firm" and "did not arise as a return on the partners' investment."

LB&I's goal in this campaign is to increase compliance with the law as supported by several recent court decisions. The "treatment streams" for this campaign include issue-based examinations and outreach to practitioners, professional service provider associations, and software vendors.

## Partnership Stop Filer

The second campaign targets partnerships that stop filing tax returns for various reasons, yet still have economic transactions that are not being reported to their partners. Consequently, such partnership activity likely is not being reported by the partners to the IRS. The treatment streams for this campaign include issue-based examinations, soft letters encouraging voluntary self-correction, and stakeholder outreach.

## Sale of Partnership Interest

The third campaign addresses taxpayers who either fail to report the sale of a partnership interest or do not report the resulting gain or loss correctly. Generally, the sale or exchange of a partnership interest results in capital gain or loss under Code Section 741. If a partner held its interest for more than one year, the long-term capital gain generally is taxed at a maximum rate of 20 percent. Higher capital gain rates may apply to the extent of depreciated real property (25 percent) or appreciated collectibles (28 percent). In addition, a portion of the gain or loss may be recharacterized as ordinary income or loss to the extent of any "hot assets" of the partnership (*i.e.*, inventory items or unrealized receivables) at the time of the sale or exchange.

For purposes of this campaign, incorrect reporting includes not only the amount of the gain or loss but also the rate applicable to such gain or loss (*e.g.*, reporting the entire gain as long-term capital gain when a portion of the gain is ordinary income or taxed at the 25-percent or 28-percent long-term capital gain rates). A variety of treatment streams are set forth to address taxpayer noncompliance, including examinations and, when appropriate, soft letters. Additional treatment streams include practitioner and taxpayer outreach, tax software vendor outreach, and tax form and publication change suggestions.

The above campaigns can be found at the following link: https://www.irs.gov/businesses/irs-announces-rollout-of-five-large-business-and-international-compliance-campaigns.

***By: Leah Gruen, Chicago***

# The Supreme Court Rejects the Government's Attempt to Merely Use "Prosecutorial Discretion" Under the Omnibus Clause

It is not often that the US Supreme Court addresses tax issues. Therefore, when the Court does address a tax issue, tax practitioners and taxpayers pay particular attention to the Court's holding. The Court did not disappoint on March 21, 2018, when it issued a decision in *Marinello v. United States*, 584 U.S. ___ (2018). *Marinello* is a particularly important decision for criminal tax prosecutions. In *Marinello*, the Court addressed the standard required for the Government to prove a defendant violated Code Section 7212(a). The so-called "Omnibus Clause" of Section 7212(a) makes it a felony "corruptly or by force" to "endeavo[r] to obstruct or imped[e] the due administration of this title." According to the Court, to convict a defendant under the Omnibus Clause, the Government must prove the defendant was aware of a pending tax-related proceeding, such as a particular investigation or audit, or could reasonably foresee that such a proceeding would commence.

## Facts

Carlo J. Marinello, II, was a taxpayer who owned and managed a company that provided courier services. According to the Court's opinion, Marinello kept almost no records of the company's earnings or expenditures. Most of the business's records were either shredded or discarded. The company's employees were paid in cash and were not given tax documents. Further, Marinello allegedly removed tens of thousands of dollars from the company each year to pay personal expenses.

Meanwhile, Marinello was unaware that the IRS was investigating his tax affairs on and off from 2004 to 2009. The IRS learned during its investigation that Marinello had not filed a tax return since at least 1992. During an interview in 2009, Marinello claimed he was exempt from filing tax returns because his income was less than $1,000 per year. He later changed his story to state he "never got around" to paying taxes.

In 2012, the Government formally indicted Marinello, charging him with violations of several criminal tax statutes including the Omnibus Clause of Section 7212(a). The Government alleged that Marinello had engaged in at least one of eight different specified activities, including "failing to maintain corporate books and records," "failing to provide" his tax accountant "with complete and accurate" tax "information," "destroying . . . business records," "hiding income," and "paying employees . . . with cash." *United States v. Marinello*, 839 F.3d 209, 213 (2d Cir. 2016).

The district court judge instructed the jury that,

> . . . to convict Marinello of violating the Omnibus Clause, it must find unanimously that he engaged in at least one of the eight practices just mentioned, that the jurors need not agree on which one, and that he did so "corruptly," meaning "with the intent to secure an unlawful advantage or benefit, either for [himself] or for another."

Importantly, the judge did not instruct the jury to find that Marinello must also have known he was under investigation and intended corruptly to interfere with the investigation. After a brief jury deliberation, Marinello was convicted on all counts.

Marinello then appealed to the Second Circuit arguing, among other things, that "a violation of the Omnibus Clause requires the Government to show that the defendant had tried to interfere with a 'pending IRS proceeding,' such as a particular investigation." The Second Circuit affirmed the district court and held that a defendant need not possess " 'an awareness of a particular [IRS] action or investigation.'" Marinello then petitioned the Supreme Court arguing that the Omnibus Clause requires the Government to prove that the defendant was aware of "a pending IRS action or proceeding, such as an investigation or audit," when he "engaged in the purportedly obstructive conduct."

## Opinion

The Supreme Court reversed the Second Circuit and rejected the Government's expansive interpretation of the Omnibus Clause. First, the Court looked to the language of the statute to determine the scope of Section 7212(a). While the literal language of Section 7212(a) is "neutral," and the statutory words "obstruct or impede" are "broad," the verbs "obstruct" and "impede" are specific to "an object—the taxpayer must hinder a particular person or thing." In Section 7212(a), "the object is the 'due administration of this title.'" And, according to the Court, due administration refers to "specific, targeted acts of administration," which is supported by the legislative history of Section 7212(a). If "due administration of this title" were a catch-all provision applying to all Code administration, then even misdemeanor offenses under the Code would turn into felonies. As the Court states:

> Interpreted broadly, the provision could apply to a person who pays a babysitter $41 per week in cash without withholding taxes, see 26 CFR § 31.3102-1(a)(2017); IRS, Publication 926, pp. 5-6 (2018), leaves a large cash tip in a restaurant, fails to keep donation receipts from every charity to which he or she contributes, or fails to provide every record to an accountant.

In *United States v. Aguilar*, 515 U.S. 593 (1995), the Court interpreted a similarly worded statute in 28 U.S.C. § 1503(a), which made it a felony to "corruptly or by threats or force, or by any threatening letter or communications [to] infleunc[e], obstruct[t], or imped[e], or endeavo[r] to influence, obstruct, or impede, the due administration of justice." In *Aguilar*, the Court held that a conviction under 28 U.S.C. § 1503(a) required a "nexus requirement," that is the defendant's "act must have a relationship in time, causation, or logic with the judicial proceeding." In imposing this nexus requirement, the Court advanced two policy reasons: (1) to exercise "restraint in assessing the reach of a federal criminal statute"; and (2) fair warning to the public as to what the law was intended to do.

According to the Court, Section 7212(a) also required a nexus "between the defendant's conduct and a particular administrative proceeding such as an investigation, an audit, or other targeted administrative action." The Court did not attempt to list every type of administrative conduct that fell within the scope of Section 7212(a), but the Court specifically stated that the nexus requirement was not met with respect to "routine, day-to-day work carried out in the ordinary course by the IRS, such as the review of tax returns."

The Government argued that the Court should allow a level of "prosecutorial discretion" under the Omnibus Clause to narrow the statute's scope. However, the Court rejected the Government's argument because in May 2017 the Office of the Attorney General issued the Department Charging and Sentencing Policy that instructed the Government to "charge a violation of the more punitive provision as long as it can readily prove that violation at trial."

Finally, in addition to the nexus requirement, the Court required the Government to "show that the proceeding was pending at the time the defendant engaged in the obstructive conduct or, at the least, was then reasonably foreseeable by the defendant." Applying a maritime analogy, the Court required the proceeding to at least be in the "offing," and it was not enough "for the Government to claim that the defendant knew the IRS may catch on to" the defendant's unlawful scheme.

## Takeaways

While the Court's decision is welcome news for taxpayers, the standards the Court required under Section 7212 to prosecute taxpayers leaves significant gray area for tax practitioners and taxpayers to interpret. First, the Court's "nexus" requirement requires the defendant's conduct to be related to a targeted tax-related proceeding (*e.g.*, an investigation or audit), but the nexus is not met when it relates to routine, day-to-day administration by the IRS. Without providing a list or more detailed description of "targeted tax-related proceedings," the Court leaves the door open as to what proceedings do meet the "nexus" requirement. Second, the defendant must either have known that a proceeding was pending or that the proceeding was reasonably foreseeable. It may be easier to prove or disprove knowledge of a pending proceeding, but reasonable foreseeability is by no means a bright line rule.

There will likely be more taxpayer challenges to the Government's prosecution under Section 7212. However, the Court's ruling requires the Government to focus its prosecution under Section 7212 on defendants who blatantly obstruct or impede the administration of the Code.

***By: Cameron Reilly, Chicago***

# Tax Court Upholds Section 956 Regulations on Guaranties

The Tax Court recently rendered a judgment against a taxpayer that the amounts of guaranties made by two controlled foreign corporations ("CFCs") were income under Code Section 956. In issuing summary judgment in favor of the Commissioner, the Tax Court expressly held that the regulations under section 956 are valid, and denied the taxpayer's own summary judgment motion seeking a finding that the regulations were invalid.

SIH Partners LLLP (the "Partnership"), was a partnership that carried on business through one of its affiliates, Susquehanna International Group ("SIG"), as an investment firm. Two of SIG's international affiliates were CFCs (the "SIG CFCs").

SIG used Merrill Lynch as its prime broker to SIG and its affiliates, meaning Merrill Lynch cleared securities and commodities transactions for SIG and its affiliates, and also provided margin loans to SIG and its affiliates. On October 2, 2007, SIG issued three notes payable to certain Merrill Lynch affiliates, with an aggregate principal amount of $1.485 billion. On that date, SIG and its affiliates (39 entities in total) executed an Amended and Restated Guaranty and Security Agreement (the "Guaranty"). Although 37 of the 39 affiliates were either US entities or disregarded for Federal income tax purposes, the SIG CFCs guaranteed the SIG notes under the Guaranty. All of the guarantors assumed joint and several liability for full payment of the SIG notes. The SIG notes remained outstanding through the end of 2008, with an unpaid principal balance of $1.285 billion.

The IRS determined that the Partnership should have included in its income for tax years 2007 and 2008 the amount of the guaranty secured by the SIG CFCs. Since enacted in 1962, Code Section 951(a) directs a US shareholder to include in its gross income its pro rata share of certain items attributable to the CFC whether or not a distribution was actually made. The inclusion amount includes the amount invested in United States property, as determined under Section 956, which includes amounts relating to an obligation of a United States person. Section 956(d) provides that a CFC "shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if…[the CFC] is a pledgor or guarantor of such obligation."

In response to the passage of Sections 951 and 956, Treasury issued a Notice of Proposed Rulemaking in 1963, setting forth a package of regulations under Section 956 and soliciting public comment on the proposed regulations. In 1964, the final regulations were adopted. In particular, Treas. Reg. § 1.956-2(c)(1) provided that any obligation of a United States person with respect to which a CFC was a pledgor or guarantor was to be considered United States property for purposes of determining the Section 951 inclusion amount. For purposes of determining the amount of the obligation, Treas. Reg. § 1.956-1(e)(2) provided that the amount taken into account was to be the unpaid principal amount on the applicable determination date.

The IRS's position was that the Partnership was required to include the amount of the Guaranty held by the SIG CFCs in its income, although the amount of the income inclusion was limited to the amount of applicable earnings of each SIG CFC for the tax years at issue (in this case, $375,392,988 in 2007 and $1,697,247 in 2008). The IRS moved for summary judgment.

The Partnership countered with its own motion for summary judgment. The Partnership challenged the validity of the 50-year-old Section 956 regulations. Specifically, the Partnership claimed that Treasury failed to engage in reasoned decisionmaking in arriving at the final regulations and that it failed to provide a reasoned explanation for its actions. The Partnership claimed that the regulations represented an unreasonable policy choice in light of the language in Section 956, as well as the statute's legislative history.

The Administrative Procedure Act ("APA"), 5 U.S.C. § 551 et seq., provides procedural rules for administrative agencies in rulemaking. In particular, rules that create rights, assign duties, or impose obligations not already outlined in the law itself (*i.e.*, "legislative rules") are subject to notice-and-comment procedures under the APA. In this case, there was no dispute that the notice-and-comment procedures were properly followed by Treasury in issuing the regulations. However, the Partnership argued that Treasury failed to meet a higher threshold of engaging in reasoned decisionmaking with regard to the regulations under Section 956. Section 706(2)(A) of the APA allows a court reviewing the actions of an agency to set aside an agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." In *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co*., 463 U.S. 29 (1983) ("*State Farm*"), the US Supreme Court required an agency to articulate a satisfactory explanation for its action, finding that an agency rule would be arbitrary and capricious if the agency relied on factors which Congress had not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that ran counter to the evidence before the agency, or was so implausible that it could not be ascribed to a difference in view or the product of agency expertise. *State Farm*, 463 U.S. at 43; *see also Altera Corp. v. Commissioner*, 145 T.C. 91 (2015). Specifically, the partnership argued that Treasury failed to engage in reasoned decisionmaking under *State Farm* and to consider "important aspect[s] of the problem" associated with CFC pledges and guaranties. See prior *Tax News and Developments* article, *Tax Court Invalidates Treasury Regulation in Altera* (August 2015).

The Tax Court disagreed, holding that the plain text of Section 956 does not require an on-the-record consideration of any particular factors in making a determination as to whether a guaranty constitutes a holding of United States property. In fact, the preamble to the final regulations only stated they were intended to conform the regulations to Section 956. The statute at issue and rules adopted did not require Treasury to engage in the analysis that the partnership was asking it to undertake. The Tax Court held,

> Treasury's decisionmaking was uncomplicated, but that does not mean the administrative process was arbitrary or otherwise deficient under the standard articulated in APA sec. 706(2)(A).

The Partnership argued that other guidance issued by the IRS and Treasury (a field service memorandum and a notice of proposed rulemaking) demonstrated that the IRS and Treasury recognized the "inadequacy" of the regulations at issue. The documents acknowledged that the regulations did not prescribe a solution for situations where multiple CFCs of the same US shareholder guaranteed the same obligations, which could allow multiple Section 951 inclusions for the same taxpayer that, in the aggregate, exceed the unpaid principal amount of the obligation. The Tax Court rejected this argument, noting that, even if the FSA and the Notice were precedential, the fact that an agency recognizes that regulations do not provide a solution for a problem does not make the regulations inadequate for administrative law purposes. Agencies retain the right to amend or issue new regulations to address these types of issues. If an agency fails to address all issues under existing regulations, that failure does not render the existing regulations invalid.

The Tax Court found that Treasury's construction of Section 956 was properly afforded deference under *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). As an initial matter, Congress did not speak directly to the precise question at issue—when and in what amount a CFC will be considered to hold United States property under Section 956 as a result of a guaranty of an obligation to a United States person. Instead, Congress left that issue to be determined under regulations prescribed by Treasury, as described in Section 956(d). Because Congress did not speak directly to the issue, *Chevron* directs the reviewing court to address whether the agency's position is based on a permissible construction of the statute, as judged under an "arbitrary and capricious" standard. Here, the Tax Court found that the rules for treatment of guaranties are not at odds with the wording of Section 956.

The holding in this case suggests the Tax Court's limits with respect to how far a taxpayer can take an argument that Treasury regulations are invalid. Taxpayers should expect that invalidating regulations will be particularly difficult where the plain language of the statute arguably leaves little room for interpretation.

***By: Daniel Wharton, Chicago***

# 2017 IRS APMA Annual Report: Some Accomplishments, but Challenges Remain

On March 30, 2018, the IRS issued its *Announcement and Report Concerning Advance Pricing Agreements* (Announcement 2018-8, I.R.B.) ("2017 APA Report"), which presents the key results of the IRS's Advance Pricing and Mutual Agreement Office ("APMA"). The 2017 APA Report provides general information regarding the operation of the office, including staffing, and statistical information regarding the numbers of APA applications received and resolved during the year, including countries involved, demographics of companies involved, industries covered and transfer pricing methods ("TPMs") employed. We summarize here the highlights of the report and provide observations based on our experience with APMA and APAs, both within the program and as tax counsel to companies in the program.

## APMA Operations

The 2017 APA Report shows that APMA faced a number of challenges in 2017 and attained some notable achievements as well. In terms of challenges, staffing decreased 10 percent while APA demand increased, inventory of pending bilateral APA requests remained high, and the time required to resolve APAs increased for most categories—and jumped significantly for unilateral APAs. Although not discussed in the 2017 APA Report, budget constraints continue to impact operations, as the APMA Director discussed previously, and new APA filing fees are scheduled to increase by approximately 45 percent after June 30, 2018, and nearly 90 percent after December 31, 2018, relative to current fees. In addition, staffing rules continue to result in temporary rotations in senior management to "acting" roles, which can result in APA case processing delays and disruptions.

Some of APMA's notable achievements include the highest number of completed APAs since 2013, reducing inventory of pending APA requests overall (unilateral APA requests by 15 percent), and handling APAs involving a more diverse set of treaty partners. In addition, building on the revised APA procedures in IRS Rev. Proc. 2015-41, APMA issued a draft model APA agreement in September 2017 and requested comments thereon.

## APMA Staffing

APMA staffing in 2017 declined 10 percent from 2016 to 72 team leaders and economists (compared with 82 in 2016) and 10 senior managers. The IRS previously stated that it intended to increase APMA's staffing to approximately 65 team leaders (up from 63 for calendar year 2016) and 30 economists (up from 20 for calendar year 2016) to improve its case processing times, but IRS budget issues and turnover have made this growth difficult to achieve. Further, although the APMA Director position was stable during 2017 and no longer in an "acting" role, there were several group managers operating in an "acting" role. In addition, there were changes in IRS Large Business & International Division ("LB&I") leadership with transfer pricing responsibilities during the year, including Treaty & Transfer Pricing Operations (Director) and Transfer Pricing Practice (Director of Field Operations). Management turnover, as well as the 2016 restructuring of the IRS LB&I Division and resource demands from the OECD-G20's Base Erosion and Profit Shifting ("BEPS") project, likely had an impact on internal operations, APA negotiations with companies, and bilateral APA negotiations involving other countries' tax authorities, thereby requiring additional time to process certain types of APAs, as discussed below.

## APA Demand and Output

***New applications:*** APA filings (including user fee filings) jumped 20 percent from 115 in 2016 to 138 in 2017, although complete filings were steady at 98 (2016) and 101 (2017). The number of filings indicates that company demand for APAs continued to grow, even during the period of tax reform uncertainty. The number of bilateral filings involving Japan increased, while those involving India decreased but were the second most numerous to those involving Japan. Bilateral filings involving Canada and Germany remained relatively steady in terms of volumes. No separate information regarding bilateral filings involving the United Kingdom and Italy was provided (unlike 2016), implying a decline in the relatively low number of filings for these jurisdictions given APMA's approach of not providing data for categories involving fewer than 3 APAs. Bilateral filings involving Switzerland were separately stated for the first time, indicating that more such filings were made in 2017 compared with 2016, but the number was relatively low.

***Processing insights:*** Pending APAs declined from 398 to 386 mainly due to a 15 percent decrease in unilateral APA inventory, which is a positive development, while bilateral APA inventory remained relatively unchanged. Of the 386 pending APAs, bilateral APAs outnumbered unilateral APAs nearly 6 to 1. Bilateral APA renewals continued to represent more than 80 percent of all pending bilateral APAs, indicating that challenges remain for APMA to resolve such renewals in a timely manner. Japan (30 percent), India (14 percent), and Canada (12 percent) represented the majority of the pending bilateral APAs, reflecting the continuing high levels of pending APAs involving Japan and Canada and the increasing levels for India. For the first time, the 2017 APA Report provides information on pending APA inventory levels involving Mexico, which were 4 percent of total inventory. The increase in pending APAs involving Mexico likely stems from recent Mexican tax law changes, although the Mexican and US tax authorities announced an agreement in September 2017 to apply a certain transfer pricing framework to resolve approximately 50 percent of the pending maquiladora industry unilateral APA requests filed with the Mexican tax authority.

In terms of processing times, APMA had difficulty improving its ability to reduce the amount of time required to complete APAs executed in 2017. Unilateral APAs executed in 2017 required twice as long to complete compared with 2016. For example, the median processing time for new and renewal unilateral APAs doubled from 15.4 months to 31 months. Bilateral APAs executed in 2017 required more time to complete compared with 2016 (35.9 months (median) compared with 35.6 months (median)), but the additional time required was relatively small. Of the 18 different measures of processing time (*e.g.*, average vs. median months, unilateral vs. bilateral APA, new vs. renewal APA), only 4 measures showed improvement in 2017 compared with 2016.

***Executed APAs:*** The IRS executed the highest number of APAs in 2017 (116) since 2013 (145). The mix of bilaterals and renewals was approximately the same as 2015, with 73 percent bilateral and 60 percent renewals.

As in prior years, the 2017 APA Report indicates that US-Japan bilateral APAs continued to constitute the largest percentage of overall APAs that the program processed (57 percent), followed by Canada (16 percent). The heavy caseload involving APAs with Japan, Canada, and India is reflected in the number of APA teams that have responsibility for those APAs and shifts in the teams that were made in 2016: two of the team leader groups have responsibility for APAs involving Japan (as well as other jurisdictions). Similarly, three of the team leader groups have responsibility for APAs involving Canada and India (as well as other jurisdictions).

***Withdrawn APA requests:*** Companies withdrew significantly fewer APAs in 2017 (8) than 2016 (24). The spike in 2016 withdrawals could be due to several factors, including a desire by APMA to "clean up" pending APA inventory, companies achieving certainty through other means, company dissatisfaction with processing times, etc. Similar to 2016, the IRS neither canceled nor revoked any APAs in 2017, and only 11 have been canceled or revoked since the program began.

## APA Characteristics and Terms

***US vs. Non-US parent companies:*** Similar to 2016, the majority of APAs continued to involve non-US parent companies: 59 percent of the executed APAs for 2017 were for non-US parent companies and their US subsidiaries, while 21 percent involved US parent companies and their non-US subsidiaries. The ongoing appeal of the APMA program to non-US parent companies, particularly Japan parent companies, could be due to, among other things, the IRS's continued focus on transfer pricing involving non-US parent companies, non-US parent companies' desire for transfer pricing certainty, or an increase in audit activity in other countries which a bilateral APA with the United States could help resolve.

***Industries represented:*** As in 2016, most of the APAs executed in 2017 involved companies in the manufacturing industry, with the next most common being wholesale/retail trade and then services. As in 2015 (but absent in 2016), APAs were also executed in the management industry as well as the finance, insurance and real estate industry category. Within the manufacturing segment, the computer and electronic products, chemical, and transportation equipment industries were relatively equally represented. To some extent, the year-over-year industry breakdown is random, in that it provides a snapshot of a particular twelve-month period, and many factors can impact the resolution timing for specific cases. The other industry classification that is prominent in the APA program is wholesale/retail trade, and merchant wholesalers of durable goods dominate that class year-over-year.

***TPMs applied:*** For 2017, the comparable profits method/transactional net margin method ("CPM/TNMM") continued to be the most commonly applied TPM for tangible and intangible property transactions (applied to 87 percent of such transactions). Regarding the profit level indicator ("PLI") used when the

CPM/TNMM is employed, the Operating Margin (defined as operating profit divided by net sales) was applied 85 percent of the time – a large jump from 67 percent in 2016. The Berry ratio, ROA, or return on capital employed PLIs were applied in the remaining cases, and the 2017 APA Report, unlike pre-2016 reports, does not separately state the number of times that PLIs other than the Operating Margin were used. Similarly, it does not include other data that had been provided in pre-2016 year reports, such as tested party functions and risks.

For services transactions, PLIs under the CPM/TNMM continued to favor the Operating Margin in 2017, with it being used for 62 percent of the services transactions (up from 43 percent in 2016). In comparison, in 2015, 55 percent of the cases applied the Mark-up on Costs, followed by 32 percent for the Operating Margin and 13 percent for the Berry ratio.

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

***APA terms:*** APA term lengths, including rollback years, averaged 7 years in 2017 (up from 6 years in 2016). The largest number of APAs were executed with five-year terms (33 percent of the total), and 78 percent had terms of 5 to 9 years. In 2017, 16 APAs had terms of 10 years or longer, which is higher than 2016 (7 APAs). In addition to the impact of aging inventory, long term lengths can be a product of complex issues, difficult competent authority negotiations and the desire for prospective coverage. For example, when a difficult or contentious case reaches conclusion, often at the end or beyond the end of the requested term, both companies and governments may seek to extend the term of an APA and provide some prospectivity.

***FX adjustments:*** The APA program has no set policy regarding adjustments to company financials to account for currency fluctuations. The 2017 APA Report notes in that regard: "In appropriate cases, APAs may provide specific approaches for dealing with risks, including currency risk, such as adjustment mechanisms and/or critical assumptions." Over the years of the APA program, FX-adjustment mechanisms have been proposed by companies and by governments, and where the fluctuations are extreme, or where a currency has weakened significantly, this can be taken into account when shaping a bilateral agreement.

## Observations and Conclusions

APMA's 2017 achievements in terms of executing a larger number of APAs, reducing APA inventory and handling APAs from a more diverse set of treaty partners are notable and should be recognized. APMA's achievements are, in part, the result of work to streamline processes (*e.g.*, intake and review processes) put in place to make the entire APA process more efficient. In addition, the increase in the information required in the APA application as the result of IRS Rev. Proc. 2015-41 was meant to reduce processing time by ensuring APMA started with the information it needed. Most of APMA's challenges in 2017 appear to stem from resource constraints, including staffing and funding limitations. With the continued need to provide companies with feasible alternatives to resolve complex transfer pricing issues as efficiently and effectively as possible, particularly with changes under the Tax Cuts and Jobs Act, increased targeted enforcement globally, heightened transparency, and BEPS pressures, it will be important to address APMA's resource constraints. Although the increased user fees effective after June 30, 2018, will augment IRS's collected fees, APMA indicated that it does not directly receive such fees as part of its budget. Such increased fees will hopefully result in more well-placed and stable resources for APMA to increase its productivity, particularly in light of the need for APMA to review and analyze the larger amounts of information and data that companies are required to submit at the front end of the APA process under IRS Rev. Proc. 2015-41.

***By: Richard Slowinski and Donna McComber, Washington, DC***

## How China's Withholding Tax Relief Affects Foreign Investors

On December 28, 2017, the Ministry of Finance, the State Administration of Taxation (SAT), the National Development and Reform Commission and the Ministry of Commerce jointly released Cai Shui [2017] No. 88 ("Notice 88"). Notice 88 allows a non-resident enterprise to defer payment of tax on dividends derived from a Chinese enterprise if, among other things, the non-resident enterprise directly reinvests such dividends into industries "encouraged" by the Chinese government. The tax deferral regime is reminiscent of the pre-2008 dividend withholding tax exemption rules. However, unlike the pre-2008 rules, Notice 88 requires the non-resident enterprise to pay back the deferred dividend withholding tax after the non-resident enterprises recovers the reinvestment. In addition to the industry requirement, the dividend tax deferral is subject to stringent fund flow conditions. Besides, Notice 88 creates some uncertainties or issues in terms of the application for the tax deferral treatment, and the SAT has tried to address some of the issues in SAT Bulletin [2018] No. 3. Unfortunately, there are still uncertainties and issues that need to be further clarified or managed, such as the revenue percentage threshold to determine whether the reinvested enterprise operates in an encouraged industry, and the indirect tax treatment if properties are transferred from the distributing enterprise to the reinvested enterprise. For a more detailed discussion of the dividend tax deferral regime and its implications on MNCs, please see the Baker client alert *"China Revives Tax Incentive for Dividends Reinvested into China*" distributed on January 5, 2017.

***By: Nancy Lai, Shanghai***

## New York Legislature Passes $168.3 Billion Budget; Includes Comprehensive Response to Federal Tax Reform

On April 17, 2018, New York State Governor Andrew M. Cuomo signed a $168.3 billion budget bill which restructures the New York Tax Law in response to Washington's enactment of the federal Tax Cuts and Jobs Act of 2017 (the "TCJA") (for prior coverage, see *Cuomo Proposes Sweeping Reforms in 30-day Amendments to Executive Budget* on the SALT Savvy blog). Specifically, the legislation (1) creates an optional employer compensation expense tax, (2) establishes a state-run charitable trust fund for the benefit of New Yorkers, and (3) decouples from several Internal Revenue Code provisions.

The legislation creates an optional Employer Compensation Expense Tax ("ECET") imposed on employers who opt-in to the regime, which is measured by the employer's annual payroll expenses in excess of $40,000. Employees covered by the ECET are permitted to take a corresponding credit to offset the New York personal income tax imposed on their wages. The regime is intended to ameliorate some of the state tax increases New York individual taxpayers are expected to face as a result of the TCJA.

The legislation also establishes a state-run charitable fund ("charitable gifts trust fund") for New York public health and education initiatives, and permits New York individual taxpayers a credit against their New York state personal income taxes measured by their contributions to the fund in the immediately preceding calendar year. Under the law, localities are also permitted to create similar funds and corresponding credits at the local level to partially offset local property taxes. The efficacy of this regime, which is ultimately intended to mitigate the impact of the TCJA's $10,000 cap on the individual state and local tax deduction, is currently up for debate given the scrutiny it is expected to receive from the IRS. If successful, however, the provision would signal a victory for high-tax states seeking a viable work-around to the TCJA's SALT deduction cap.

Finally, the legislation decouples from several Internal Revenue Code provisions in response to changes made by the TCJA, including, among others, the SALT deduction cap and the deduction provided by IRS § 965(c). Overall, the New York FY 19 budget legislation represents a sweeping response to the enactment of the TCJA, with many more states expected to follow suit in the coming months. Be on the lookout for more updates, both here and on the SALT Savvy blog at www.saltsavvy.com.

***By: David Pope and Michael Tedesco, New York***

## Summary Judgment Denied (Again) in District of Columbia Transfer Pricing Cases

ExxonMobil Oil Corporation, Hess Corporation, and Shell Oil Company (collectively, the "Oil Companies") suffered yet another setback in their ongoing fight against the District of Columbia Office of Tax and Revenue's ("OTR")

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

reliance on a controversial transfer pricing method employed by Chainbridge Software LLC, the OTR's third-party transfer pricing consultant. Most recently, in *Hess Corp., et. al. v. D.C. Office of Tax & Revenue*, Case Nos. 2012-OTR-00027, 2011-OTR-00047, 2011-OTR-00049 (Jan. 26, 2018), an Office of Administrative Hearings ("OAH") Administrative Law Judge denied the Oil Companies' motion for summary judgment, holding that the Oil Companies failed to establish that the transfer pricing method employed by Chainbridge was arbitrary, capricious, and unreasonable as a matter of law. This development follows the Oil Companies' unsuccessful attempt last year to estop the OTR from relitigating the validity of Chainbridge's transfer pricing methodology in light of the OAH's holding in *Microsoft Corp. v. Office of Tax and Revenue (2012)* that the Chainbridge methodology was arbitrary, capricious, and unreasonable.

The Oil Companies asserted that Chainbridge improperly applied the comparable profits method ("CPM")—whereby Chainbridge compared each of the Oil Company's profit-to-cost ratios against the profit-to-cost ratios of third parties it deemed to be comparable—because: (1) Chainbridge failed to separate related party ("controlled") transactions from third-party ("uncontrolled") transactions when determining their profit-to-cost ratios, (2) Chainbridge erroneously applied the CPM at the entity level, thereby aggregating multiple product lines with different functions, and instead should have evaluated each of the Oil Company's related products and business segments on a separate basis, and (3) Chainbridge's analysis did not allow for "correlative allocations," *i.e*., downward adjustments to the income of other members of the Oil Companies' controlled group affected by the OTR's "primary allocation" (*i.e*., the adjustment increasing the income of the Oil Companies). In response, the ALJ held that there were several questions of fact with regard to objections (1) and (2), above, that warranted further factual development. As to the Oil Companies' third contention, the ALJ held that correlative allocations were not required because primary allocations are not considered to have been made under the federal section 482 regulations (which interpret section 482 of the Internal Revenue Code, upon which the OTR's transfer pricing authority is based) until "the date of a final determination with respect to the allocation." A status conference in the matter was last held March 7, 2018.

For a full discussion of *Hess Corp., et. al. v. D.C. Office of Tax & Revenue* and the implications of the OAH's decision, please see *Summary Judgment Denied (Again) in District of Columbia Transfer Pricing Cases* on the SALT Savvy blog at www.saltsavvy.com.

***By: Lindsay LaCava and Michael Tedesco, New York***

## Discuss US Tax Reform with Baker McKenzie at upcoming events in New York and Washington, DC

You are invited to two upcoming educational events to learn more about the impact of US and Global tax reform and their impacts on tax planning, transactions and transfer pricing.

Baker McKenzie

www.bakermckenzie.com

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

## US and Global Tax Reform: Tax Planning Reimagined New York │ May 23

The 15th Annual Tax Planning & Transactions Workshop, ***US and Global Tax Reform: Tax Planning Reimagined***, will focus on global and industry-specific implications of tax reform, and specialized topics ranging from the practical implications of tax reform to identifying the necessary building blocks for tax planning and other impacts of the tax system globally.

Every year, this workshop is viewed as a "must-attend" by clients. This full-day event will occur May 23, 2018 at the New York Hilton Midtown.

Learn more and register at www.bakermckenzie.com/tax/events.

## Bloomberg BNA and Baker McKenzie Global Transfer Pricing Conference │ Washington, DC │ June 6-7

Learn about the transfer pricing implications of the Tax Cuts and Jobs Act at our fifth annual Global Transfer Pricing Conference, co-hosed with Bloomberg BNA. Top government and regulatory officials, policy makers and peers will discuss how governments plan to implement the new law, how companies are adjusting their transfer pricing strategies, and how the reduced corporate tax rate could impact other countries and WTO rules amongst a variety of other topics.

This two-day event takes place June 6-7 at The National Press Club in Washington, DC.

To view the agenda and register, visit www.bna.com/globaltransferpricing-dc. We are pleased to offer you a discounted rate of $1,095 when you register using the code BAKDC18 at checkout. Groups of two or more can register at the discounted rate of $995 each by using code GRPDC18 at checkout.

*Tax News and Developments* is a periodic publication of Baker McKenzie's North America Tax Practice Group. The articles and comments contained herein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases. Past performance is not an indication of future results.

*Tax News and Developments* is edited by Senior Editors, James H. Barrett (Miami) and David G. Glickman (Dallas), and an editorial committee consisting of Glenn G. Fox (New York), Gwen Hulsey (Houston), Joseph A. Myszka (Palo Alto), John Paek (Palo Alto ), Alex Pankratz (Toronto), Julia Skubis Weber (Chicago), Angela J. Walitt (Washington, DC), and Robert S. Walton (Chicago).

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.

**Your Trusted Tax Counsel ®**

**www.bakermckenzie.com/tax**