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In This Issue:

Lame Duck May End with a Whimper, but 2019 Will be a Busy Year in Tax Policy

Next year may be a jam packed year in tax policy. This article will discuss changes in Congress that could create opportunities and risks for taxpayers in 2019 and beyond. It will also address potential developments in tax policy.

Lame Duck 2018

The 115th Congress may end with little or no action on tax legislation. Funding for the federal government expires on December 21, 2018. One of many areas of disagreement between the parties and the branches of government is whether to provide $5 billion in funding for the border wall. If a deal cannot be reached, then the government would shutdown until the parties reach an agreement. A shutdown would impact tax guidance, as many employees at Treasury and the IRS would be barred from working.

After the election, the tax community had a glimmer of hope that a year end omnibus bill could include tax extenders, pension reform (a priority for retiring Senate Committee on Finance Chairman Orrin Hatch), IRS reform (a bipartisan bill that would provide a right to go to IRS appeals, among other items), and possibly a few Tax Cuts and Jobs Act of 2017 ("TCJA") technical corrections. Unfortunately, the houses have not reached agreement on whether to include any tax provisions in the end of year funding bill. House Ways and Means Chairman Kevin Brady filed two bills (amendments to H.R. 88). The first version included tax extenders, the second one removed extenders and included Republican priorities that would be rejected by Democrats. The second version of the bill indicates that the parties are far apart, and as of the writing of this article, there is not a path for passing the Brady bill in both houses.

Chairman Brady announced that he has a list of roughly 80 technical corrections to the TCJA. At this point, he released a handful in the two versions of his bills. Technical corrections include qualified improvement property, the net operating loss effective date, transition tax overpayment, and revisions to downward attribution designed to limit the application to decontrolling transactions by foreign-parented multinational businesses. Democrats are critical of technical corrections, as the Republicans cut the Democrats out of the TCJA process by using reconciliation.

Upcoming Tax Events

Current Developments in Chinese Tax and Transfer Pricing Controversy Webinar

► January 8, 2019

41st Annual North America Tax Conference

Mexico City, Mexico
► January 31, 2019

Global Tax Disputes Forum

Milan, Italy
► February 7, 2019

Latin America Tax Conference

Miami, Florida
► April 2-3, 2019

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

Thus, Congress may end the year by either passing a continuing resolution to keep the lights on or with a shutdown. It is highly unlikely that a continuing resolution will include extenders.

A Busy Year in Tax Policy

The 116th Congress will be engaged in tax policy. First, both tax writing committees will have new chairmen. Senator Chuck Grassley (R-Iowa) will become the chair of the Senate Committee on Finance. Under Senate Republican rules, he can serve as Chairman for two years, and then will need to hand over the gavel to either the next Republican in line (Senator Crapo from Idaho) or a Democrat if the Senate changes control. Senator Grassley likes hearings and oversight. We anticipate a busy calendar once the incoming chairman sets his priorities for 2019.

The House will change control as a result of the 2018 midterm elections. Congressman Richie Neal (D-Massachusetts) will become the chairman of the Committee on Ways and Means, and it is likely that congressman Mike Thompson (D-California) will become the chairman of the Tax Policy Subcommittee. Democrats in the House were shut out of the TCJA process, and they will hold a series of hearings to explore the tax reform law. Hearings will likely focus on how the new law works, policy decisions, and flaws. On the business side, there will be a focus on the international tax provisions, including global intangible low taxed income ("GILTI") and the base erosion and anti-abuse tax ("BEAT"). One possible outcome of this process is a bill to address technical corrections and policy changes to the TCJA. Also, the incoming chairman, like former Chairman Dave Camp, could introduce draft legislation that could form the basis for additional tax reform.

Congressman Neal will also focus on pension and retirement issues, and he may introduce legislation in 2019. There is bipartisan and bicameral interest in this area, and it is possible that both houses could reach agreement. Also, the bipartisan IRS reform could be enacted.

Another area for agreement is extenders. Roughly 30 provisions expired at the end of 2017, and Congress will need to take up extenders in the first quarter of 2019. Both parties and both houses would like to see these provisions extended. Also, new extenders may enter into the fray in 2019 (e.g., the change in the new thin capitalization rules from effectively EBITDA to EBIT in 2022).

House Democrats will likely adhere to pay go, which means any new outlay must be offset by spending cuts or revenue increases. As a result, Democrats will need to generate a list of pay-fors. Taxpayers, especially corporations, may spend the next year or two playing defense.

Ways and Means will also engage in oversight that may differ in scope from Senate Finance. For example, the new Ways and Means chairman will likely

request President Trump's tax returns and those of his businesses pursuant to section 6103(f)(1). This could lead to oversight of the President, his businesses, and other related activities. Additionally, the House could investigate tax issues or specified taxpayers. For example, Congressman Jan Schakowsky (D-Illinois) sent a letter to five pharmaceutical companies requesting information on various activities, including a request for their country-by-country reports.

Treasury and the IRS

While Congress will focus on its business, Treasury and the IRS intend to finalize most or all of the TCJA guidance by June 22, 2019. Any guidance finalized by that date could be retroactive to the date of enactment of the TCJA. See section 7805(b)(2).

Treasury will publish final section 965 regulations (transition tax) in the coming weeks, as well as proposed regulations on foreign derived investment income, anti-hybrids, and previously taxed income. Treasury will then review other regulations and make modifications to reflect the TCJA.

While Treasury proposed revoking the documentation rules under section 385, it has yet to review or modify the per se and funding rules. Treasury recently indicated that it will undertake that review in 2019. Even if Treasury does not modify the final regulations, it will need to address the cash pooling and other favorable rules contained in the temporary regulations that expire in October 2019.

Treasury will also be busy at the OECD. The OECD will continue to work on the digital economy, and there is interest in looking at strengthened controlled foreign corporation ("CFC") rules. One option under consideration is GILTI on a per country basis.

Conclusion

The coming year promises to be an extremely busy year in US tax policy. Stakeholders should engage with policy makers to ensure their priorities and concerns are addressed.

By: Joshua Odintz and Alexandra Minkovich, Washington, DC

Proposed Regulations Reduce Income Inclusions for CFC Shareholders

Change often necessitates adaptation. Although the US federal tax regime was recently changed by Congress to a territorial tax regime under the so-called Tax Cuts and Jobs Act ("TCJA"), the TCJA did not adapt all sections of the Code to account for such change. Section 956 was one such section generally

unaffected by the TCJA. Because section 956 remained unchanged, transactions that as a policy matter should no longer be taxed, were still being included in income under section 956. Aware of this fact, the IRS and Treasury announced significant adaptations to section 956. Through proposed regulations ("Proposed Regulations") issued October 31, 2018 the application of section 956 to US corporations ("Corporate US Shareholders") will be significantly narrowed in scope with regard to amounts considered substantially equivalent to dividend distributions between Corporate US Shareholders and their controlled foreign corporations ("CFCs").

Before the TCJA, Corporate US Shareholders were subject to tax on their worldwide income under subpart F and section 956. Subpart F prevented indefinite deferral of certain income of CFCs, generally passive or highly mobile income, by subjecting such income to immediate taxation before it had been distributed to Corporate US Shareholders in the form of a dividend. The preamble to the Proposed Regulations states: "the purpose of section 956 is generally to create symmetry between the taxation of actual repatriations and the taxation of effective repatriations, by subjecting effective repatriations to tax in the same manner as actual repatriations." For example, section 951(a)(1)(B) generally required Corporate US Shareholders that are regarded as corporations for US federal tax purposes of a CFC to include in gross income its pro rata share of amounts determined under section 956. Through section 956, Congress sought to tax loans or other investments in United States property ("US property") that were substantially equivalent to dividends, such as tangible property located within the US, and loans provided to Corporate US Shareholders. Because such amounts would be included in gross income under section 956, the ability of the Corporate US Shareholders to defer US taxation of those earnings was limited. Such amounts were taxed because Congress viewed them as substantially equivalent to dividend distributions, but, unlike actual dividend distributions, such amounts escaped taxation under section 301. Prior to the TCJA, section 956 provided symmetry between actual dividends, and amounts that were substantially equivalent to a dividend distribution, thus ensuring US corporations paid tax on their worldwide income.

However, on December 22, 2017, Congress passed the TCJA, transitioning the U.S. federal tax regime to a territorial system, which generally will only tax income earned within the U.S. Under new section 245A, a Corporate US Shareholder generally receives a full deduction for dividends received from most CFCs. Because earnings of a CFC distributed to a Corporate US Shareholder as dividend distributions are now generally exempt from U.S. federal income tax, the abuse Congress was intending to quell when it enacted section 956 in 1962 no longer exists. Failing to adapt section 956 to changes accompanying the TCJA would frustrate the new territorial tax regime, and create an asymmetry between the treatment of actual dividend distributions and amounts considered substantially equivalent to dividend distributions. The former would continue to be subject to tax under an un-adapted section 956, while the latter would be exempt from tax under new section 245A.

As such, the IRS and Treasury determined that the current broad application of section 956 to Corporate US Shareholders is no longer necessary to achieve symmetry between actual and deemed dividends from CFCs. To remedy this asymmetry, the Proposed Regulations provide that the amount otherwise determined under old section 956 "is reduced to the extent that the [Corporate U.S. Shareholder] would be allowed a deduction under section 245A if the shareholder had received a distribution from the CFC in an amount equal to the amount otherwise determined under section 956." For example, a loan of $100 from a CFC to its Corporate US Shareholder would not be included in income under new section 956, because if that same $100 has been distributed instead of loaned, the Corporate US Shareholder would have been eligible for a deduction under new section 245A. Adapting section 956 in this manner would promote symmetry between the treatment of actual and effective dividends, while facilitating the US transition to a territorial tax regime post TCJA. However, it should be noted that the Proposed Regulations do not affect shareholders other than Corporate US shareholders, because only Corporate US Shareholders are eligible for a dividend received deduction under section 245A.

If the Proposed Regulations are enacted as written, common cross-border financial transactions between Corporate US Shareholders and their CFCs will no longer be subject to corporate tax, enabling Corporate US Shareholders the ability to leverage the assets of their CFCs without tax reckoning. For example, Corporate US Shareholders may receive lower interest rates on third party loans by having a larger pool of assets to use as collateral, can obtain loan financing directly from a CFC, and can receive investments in US property directly from a CFC.

By Nicholas Serra, Chicago

TCJA - So Many Questions, So Little Time

The TCJA provides a legislative framework, but Congress left a significant number of questions to be answered in guidance implementing the new law. Now Treasury and the IRS must fulfill their mandate by issuing guidance, and in the process make numerous substantive decisions. These decisions will affect the operation, administrability and complexity of the tax system going forward. Treasury has a general deadline of June 2019 for guidance to be effective as of the date the TCJA was enacted. In the meantime, without guidance, taxpayers will be required to make their own reasonable interpretations of what the TCJA requires when filing their tax returns. The article, "*TCJA - So Many Questions, So Little Time*", provides some examples illustrating areas where guidance is needed and identifies what considerations taxpayers should take into account in the short term.

By Julia Skubis Weber, Chicago

Communications With Accountants Hired By Tax Counsel Are Privileged Under *Kovel*

In an October 2018 order, *United States v. Adams*, No. 0:17-cr-00064-DWF-KMM, the U.S. District Court for the District of Minnesota held that the attorney-client privilege extended to communications between taxpayer Edward S. Adams and accountants at Murry & Associates, LLC ("Murry LLC"), who were retained by Adams's tax attorney, Thomas B. Brever, under a *Kovel* arrangement. *Kovel* refers to *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), where the Second Circuit held that the attorney-client privilege may be extended to non-lawyer consultants, such as accountants, who might be retained by a client's lawyers.

The Parties' Positions

Mr. Adams claimed that his communications with accountants at Murry LLC are protected by the attorney-client privilege.

First, the government argued that the protections provided under *Kovel* did not apply to the individual communications between Adams and the accountants at Murry LLC.

Second, the government argued that, even if the protections of *Kovel* did apply, any protection was waived by Mr. Adams's subsequent filing of amended tax returns.

And third, the government argued that, again even if the protections of *Kovel* did apply, the crime-fraud exception vitiates any claim of privilege. When Adams filed amended tax returns in 2014 with the assistance of Murry LLC for tax years 2008, 2009, and 2010, he disclosed income from the sale of stocks. The government argued that by reporting that his income came from the sale of stocks, rather than through the sale of warrants, Adams was able to obtain significant tax savings because the tax rate for the sale of stocks is lower. The government believed that Adams communicated with Murry LLC and Brever to get advice that would further the submission of fraudulent tax returns.

Application of *Kovel*

The court conducted an *in camera* review of several of the Murry communications. The court held that the attorney-client privilege provided under *Kovel* extended to the communications at issue.

The attorney-client privilege protects confidential communications between a client and an attorney that are made for the purpose of obtaining legal advice. *United States v. Yielding*, 657 F.3d 688, 706 (8th Cir. 2011) (citing *United States v. Horvath*, 731 F.2d 557, 561 (8th Cir. 1984)). The party asserting that a communication is protected by the attorney-client privilege has the burden to establish that it applies. *Hollins v. Powell*, 773 F.2d 191, 196 (8th Cir. 1985). The attorney-client privilege may be extended to non-lawyer consultants, such as

accountants, who might be retained by a client's lawyers. *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961).

Mr. Adams' tax counsel provided declarations to the court in which he "thoroughly explain[ed] how communications with Murry LLC and the information Mr. Adams provided to the accountants assisted in Mr. Brever's provision of legal advice to his client regarding tax-related matters." Citing *Kovel*, the court held that this explanation was "sufficient to invoke the attorney-client privilege." *See Kovel*, 296 F.2d 921-22 (explaining that where an attorney retains an accountant to assist the lawyer in providing legal advice to a client concerning tax issues, the attorney-client privilege may extend to communications between the client and the accountant); *see also United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972) (concluding that attorney-client privilege may apply where "the accountant's aid to the lawyer preceded the advice and was an integral part of it")."

The court noted that its *in camera* review of the communications did not contradict Mr. Brever's explanation.

The court emphasized that its rejection of the government's challenge to the assertion of privilege regarding specific documents was "expressly limited to these documents. The court's rulings should not be read to strengthen or weaken claims of privilege or discoverability as to other documents, evidence, or testimony as those issues are not now before the court."

Waiver By Filing Amended Returns

The court held that the attorney-client privilege as to the Murry communications submitted for *in camera* review was not waived by his filing of amended tax returns for 2008, 2009, and 2010.

The attorney-client privilege could apply to communications between a client and an accountant who is retained to assist an attorney in providing legal advice on tax matters, but by filing amended returns, taxpayers may communicate, at least in part, the substance of that information to the government, and therefore waive the privilege. *See United States v. Cote*, 456 F.2d 142, 144 (8th Cir. 1972). However, the *Cote* court noted that "[t]oo broad an application of the rule of waiver requiring unlimited disclosure by reason of filing an income tax return might tend to destroy the salutary purposes of the privilege which invite confidentiality between the attorney and his client." *Id.* at 145 n.4. The *Cote* court distinguished between "workpapers [that] contain detail of unpublished expressions which are not part of the data revealed on the tax returns," and other workpapers to which the rule of waiver would apply. *Id.*

The court noted that in responding to a subpoena from the government, Mr. Adams's counsel provided copies of files that contain data and information that was included on the amended returns for 2008-2010, but "he did not disclose information communicated by Mr. Adams in connection with requests for legal advice." The court concluded that this fact distinguished the case from

Cote, wherein the accountant had "testified that the information on his workpapers was later transcribed onto the amended returns which were filed by the taxpayers with the government," thereby waiving the attorney-client privilege. *See* 456 F.2d at 145.

The court concluded that the information conveyed to the accountants at Murry LLC comprised the type of unpublished expressions that were not later revealed on the amended tax returns.

Crime Fraud

Under the crime-fraud exception, the attorney-client privilege "does not extend to communications made for the purpose of getting advice for the commission of a fraud or a crime." *United States v. Zolin*, 491 U.S. 554, 563 (1989). Though the attorney-client privilege protects an individual's consultation with a lawyer "with respect to past wrongdoings," the privilege is lost if the communication is made "to further a continuing or contemplated criminal fraud or scheme." *In re Green Grand Jury Proceedings*, 492 F.3d 976, 979 (8th Cir. 2007). Similarly, "a client who has used his attorney's assistance to perpetrate a crime or fraud cannot assert the work product privilege as to any documents generated in furtherance of his misconduct." *Id.* at 980. Before the exception may be applied, the government must make a threshold showing that legal advice was obtained to further an illegal or fraudulent scheme. *See United States v. Horvath*, 731 F.2d 557, 562 (8th Cir. 1984) (citing *Clark v. United States*, 289 U.S. 1, 15 (1933)). The party invoking the crime-fraud exception is only required to demonstrate "a factual basis adequate to support a good faith belief by a reasonable person . . . that *in camera* review of the materials may reveal evidence to establish the claim that the crime-fraud exception applies." *Zolin,* 491 U.S. at 572; *In re Green Grand Jury Proceedings*, 492 F.2d at 982.

The court held that the government met the initial threshold because "a reasonable person could form a good faith belief that the Murry communications may reveal that Mr. Adams sought legal advice in furtherance of filing fraudulent tax returns." The fact that Mr. Adams sought advice shortly before filing his amended tax returns, paired with documents indicating Mr. Adams was actually selling warrants instead of stocks, was enough to satisfy the prima facie requirement. To make the ultimate showing that the crime-fraud exception applies there must be a showing that the attorney's assistance was obtained in furtherance of the criminal act or closely related. The court declined to go into an in-depth discussion of the communications as it would reveal privileged communications. After reviewing the Murry communications, the court found that the government failed to make the ultimate showing that the exception applied because the communications did not provide reasonable cause to believe that Mr. Adams obtained the advice with the intent to commit a crime. The court held that the crime-fraud exception did not apply.

By Michael Farrell, Dallas* and *Eric Biscopink, Washington, DC

Treasury Issues Proposed Regulations Limiting Interest Deductibility

On November 26, 2018, Treasury and the IRS released proposed regulations relating to the rules regarding the limitation on the deduction for business interest expense under section 163(j). The proposed regulations attempt to implement the substantial amendments to section 163(j) enacted as part of the Tax Cuts & Jobs Act ("TCJA"). Consistent with these amendments, the proposed regulations limit any taxpayer's deduction for business interest expense to the sum of: 1) the taxpayer's current-year business interest income; 2) 30% of the taxpayer's adjusted taxable income; and 3) certain floor plan financing interest expense. The limitations of the amended statute and proposed regulations apply equally to interest paid to related and unrelated parties. Interest expense that cannot be deducted currently because of the limitation under section 163(j) can be carried forward and treated as business interest expense in future years. The proposed regulations and the preamble to the proposed regulations span almost 450 pages.

Baker McKenzie will issue a client alert summarizing the main aspects of the proposed regulations and noting our observations on particular points of interest.

By Thomas May, New York

Proposed Foreign Tax Credit Regulations

On November 28, 2018, Treasury and the IRS released proposed regulations relating to foreign tax credits ("FTCs"). The proposed regulations cover a wide range of topics and attempt to conform the changes from the Tax Cuts & Jobs Act ("TCJA") with respect to a number of Code provisions, including sections 78, 861, 904, and 960. In over 300 pages of text, this set of rules addresses: allocating expenses to the new global intangible low-taxed income ("GILTI") basket; allocating and apportioning interest expense, research and experimental expenditures, and foreign income taxes; transitional rules for FTC carrybacks and carryforwards; new CFC netting rules; allocating income to the new foreign branch income basket; basketing the section 78 gross-up; and the application of the new "properly attributable to" standard in revised section 960 for purposes of determining a US shareholder's deemed paid FTCs for subpart F inclusions, GILTI inclusions, and distributions of previously taxed earnings and profits ("PTEP") from one of ten new PTEP groups. The rules generally require taxpayers to allocate only half of their otherwise allocable expenses to the GILTI basket. The proposed regulations would also deny deemed paid FTCs with respect to section 956 inclusions.

Baker McKenzie will issue a client alert summarizing the main aspects of the proposed regulations and noting our observations on particular points of interest. Any written or electronic comments on the proposed regulations and requests for a public hearing must be received by Treasury before February 5, 2019.

By Matthew Jenner, Chicago

Pennsylvania Court Finds IP Not Subject to Sales Tax

The Pennsylvania Supreme Court recently held that royalty fees for certain intellectual property were not subject to sales tax. The royalties at issue were payments between third parties for IP used in the operation of gaming machines ("Gaming IP"). The Commonwealth argued the Gaming IP was canned software, and thus taxable in Pennsylvania. The Commonwealth also argued, in the alternative, that sales tax was due on the full price paid for the gaming machines along with any ancillary items, such as the Gaming IP. In siding with the taxpayer, the court found the Gaming IP was not subject to sales tax because it did not constitute, nor was it ancillary to, tangible personal property. For more information on the case and what it may mean for taxpayers, please see "*Pennsylvania Court Finds IP Not Subject to Sales Tax*" on the SALT Savvy blog, available at www.saltsavvy.com.

By Trevor Mauck, New York

Supreme Court of Canada Sides With Lenders: the *Callidus* Decision

Canadian tax end employment legislation creates so called "super-priorities" with respect to certain amounts collected or withheld by businesses and employers. For example, where an employer withholds amounts on account of income taxes from an employee's pay cheque, a deemed trust is created in respect of those amounts, which will generally take priority over all claims against the employer by secured creditors, both pre- and post-bankruptcy.

Similarly, subs. 222(1) of the *Excise Tax Act* ("ETA") creates a deemed trust in respect of amounts that a person collects as GST/HST (the "Tax Debtor Trust"). Furthermore an amount paid out of the Tax Debtor Trust to a secured creditor generally creates a deemed trust in the hands of the secured creditor pursuant to subs. 222(3) ETA, (the "Secured Creditor Trust").

Take, for instance, a situation where a business has collected GST/HST from its customers but has failed to remit same to the Crown, and instead spends such amounts on business expenses. Subsequently, the business obtains a mortgage from a secured creditor with respect to a commercial property. Upon sale of the commercial property, a portion of the proceeds of the sale are paid to the secured creditor. Pursuant to s. 222 ETA, the amounts received by the secured

creditor are deemed to be held in trust for the Crown up to the amount of the unremitted GST/HST.

Section 222(1.1) ETA clearly states that the Tax Debtor Trust is extinguished upon bankruptcy of the tax debtor; however, there is no such provision directly tailored to the Secured Creditor Trust. Accordingly, until recently, it remained an open question as to whether the bankruptcy of a tax debtor extinguished the deemed Secured Creditor Trust. In *Callidus Capital Corporation v. The Queen* (2018 SCC 47), the Supreme Court of Canada ("SCC") addressed this issue, concluding that bankruptcy of the tax debtor did in fact extinguish the deemed Secured Creditor Trust, thus providing commercial certainty to secured creditors.

Facts

In *Callidus*, a real estate investment company (the "Tax Debtor") collected GST/HST between 2010 and 2013, but failed to remit same to the Canada Revenue Agency ("CRA"), thus creating a Tax Debtor Trust. In December 2011, the Tax Debtor defaulted on various secured credit facilities with its bank and the bank, in turn, assigned the debts to the Appellant, Callidus. Callidus and the Tax Debtor entered into a forbearance agreement December 2, 2011, which required the Tax Debtor to: (1) sell a commercial property and remit the net sale proceeds to Callidus; and (2) pay to Callidus rent monies that the Tax Debtor collected on another property. On April 2, 2012, CRA wrote to Callidus claiming an amount on the basis of the Secured Creditor Trust; however, Callidus did not pay any amounts to CRA. The commercial property was sold on April 5, 2012 and proceeds from the sale were paid by the Tax Debtor to Callidus against its debt on April 9, 2012, which were applied to partially reduce the Tax Debtor's debt with Callidus. All amounts received by the Tax Debtor as rent on the other property between December 2011 and July 2014 were deposited into blocked accounts and also applied to partially reduce the Tax Debtor's debt with Callidus.

On November 7, 2013, the Tax Debtor made an assignment into bankruptcy at the request of Callidus. Less than a month later, the CRA commenced a proceeding against Callidus claiming that the amounts initially forming the Tax Debtor Trust had transformed into a Secured Creditor Trust by virtue of the payments of rent and sale proceeds to Callidus, and that the Secured Creditor Trust survived bankruptcy. Callidus defended the action, taking the position that its claim was in priority to CRA's as both the Tax Debtor Trust and Secured Creditor Trust were extinguished upon the Tax Debtor's November 7, 2013 bankruptcy and thus were not payable to CRA.

Federal Court Decision

The court of first instance - the Federal Court of Canada ("FC") - agreed with Callidus (2015 FC 977). Namely, it concluded that although subs. 222(3) ETA created an "absolute priority" in favor of the Crown with respect to the Secured Creditor Trust, such priority was extinguished upon the Tax Debtor's bankruptcy. The FC reasoned that the Secured Creditor Trust is dependent upon the continuing existence of the Tax Debtor Trust; therefore, when the Tax Debtor

Trust is extinguished upon bankruptcy by virtue of subs. 222(1.1), the Secured Creditor Trust is also extinguished. The FC noted that the enactment of subs. 222(1.1) appeared to align with Parliament's intention to move away from asserting priority for Crown claims in insolvency law and that while source deduction deemed trusts remain operative in bankruptcy, GST/HST deemed trusts do not.

Federal Court of Appeal Decision

The Crown appealed to the Federal Court of Appeal ("FCA") which allowed the appeal in the Crown's favor in a split 2 to 1 decision (2017 FCA 162). The majority concluded that while subs. 222(1.1) releases a tax debtor's assets from the Tax Debtor Trust upon bankruptcy, the subsection does not extinguish the pre-existing personal liability of a secured creditor who received proceeds from the Tax Debtor Trust prior to bankruptcy. The debt arising from the Secured Creditor Trust is due and can be pursued by the Crown in a cause of action independent of any subsequent bankruptcy proceedings. The majority noted that Callidus' proposed interpretation would allow a secured creditor to manipulate both pre- and post-bankruptcy priority, by simply not abiding by the pre-bankruptcy priority, while subsequently requesting that post-bankruptcy priority be enforced.

The dissenting judge at the FCA concluded that the Secured Creditor Trust lapsed due to a lack of subject matter by operation of subs. 222(1.1) following Tax Debtor's bankruptcy and the fact that Callidus did not make any pre-bankruptcy payments to CRA was irrelevant. Specifically, the dissenting judge noted that it was the Tax Debtor's failure to remit the GST/HST collected that gave rise to the Secured Creditor Trust - not the Secured Creditor's failure to pay CRA; therefore, if no amounts are deemed to be held in the Tax Debtor Trust, no Secured Creditor Trust arises. In other words, the creation of the Secured Creditor Trust depends on the existence of the Tax Debtor Trust and once bankruptcy occurs, the Tax Debtor Trust and, in turn, the Secured Creditor Trust is extinguished. In this regard, the dissenting judge noted that the Secured Creditor Trust varies with the amount of the Tax Debtor Trust such that a payment by the Tax Debtor to CRA would have the effect of reducing the Secured Creditor Trust. While the dissenting judge noted that Callidus' proposed interpretation results in a situation where a secured creditor has an incentive to resist payment to CRA pre-bankruptcy in the hopes that the Tax Debtor Trust will be extinguished (and in fact could help the matter along by petitioning the tax debtor into bankruptcy), this result does not put the Crown's interest unjustifiably at risk.

Supreme Court of Canada Decision

Callidus successfully appealed the FCA decision to Canada's highest court. In a rare move, the SCC delivered its unanimous decision from the bench, simply adopting the reasons of the dissenting judge at the FCA, and reinstating the

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order of the FC in favor of Callidus. The SCC chose not to comment on the scope of the deemed trust or any liability under s. 222 *prior* to bankruptcy.

Key Takeaways

The SCC's decision is welcomed from both a technical and policy perspective. It properly recognizes that the Tax Creditor Trust forms the basis for the Secured Creditor Trust, and that it must follow that the extinguishment of the former results in extinguishment of the latter. Further, providing secured creditors with at least the same protection as the actual tax debtor post-bankruptcy seems to be sound policy. In any event, secured creditors' post-bankruptcy obligations with respect to a tax debtor's unremitted GST/HST have finally been clarified, which provides welcomed certainty for lenders.

By Bryan Horrigan, Toronto

Multinational Supply Chains and Intangible Assets Under the Australian Taxation Office's Microscope

During November, the Australian Taxation Office ("ATO") released two significant pieces of transfer pricing guidance.

Firstly, the ATO released a draft Practical Compliance Guideline ("PCG") discussing transfer pricing issues for inbound Australian distributors ("PCG 2018/D8"). This draft guidance provides a clear indication of the profit margins which the ATO considers are appropriate for Australian distribution operations. Unsurprisingly, the margins identified by the ATO are significantly above the transfer pricing margins that many groups have historically recognized for their Australian distributors. The outcome is that a large majority of Australian distribution subsidiaries will now sit in the ATO's defined "high risk" zone.

The draft PCG provides specific profit guidance for the technology, health science and automotive industries, as well as general profit guidance for all other industries.

The ATO takes the opportunity to assert its view on the unique "value adding" role of inbound distributors in the Australian market. For example, it states:

> "*Inbound distributors play an important role as a value-adding link between foreign entity suppliers and customers. Inbound distributors seek to find and match suppliers' capabilities with customers' buying preferences."*

While this value add argument might hold true for some organizations, the ATO guidance takes a very broad approach which, arguably, fails to recognize the many different business models and distribution channels used by multinationals selling into the Australian market. Ultimately, where taxpayers find themselves in

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a higher risk category, they will need to carefully and critically evaluate their specific facts and circumstances against the ATO guidance. Where taxpayers wish to maintain a "higher risk position", they need to prepare comprehensive analysis, including a detailed two-sided functional analysis and a well reasoned TP characterization, which will form the basis to defend against any ATO challenge.

The second piece of guidance is a Taxpayer Alert ("TA2018/2"). This alert provides a clear statement on the ATO's intention to find embedded royalties in consideration which is being paid by Australian distributors to their foreign affiliates. Beyond including two high level examples, the Taxpayer Alert does not provide taxpayers with further detail which would be helpful in assessing more complex fact patterns. However, based on our experience of current ATO compliance activities, the ATO is increasingly wanting to understand the detailed nature of intercompany relationships, in order to form a view to forming a view on what local subsidiaries are actually paying for. Again, this underlines the importance of clearly delineating intercompany transactions and developing a detailed functional analysis which will help avoid any ambiguity on the nature of such payments. For a more thorough discussion, please see the Baker McKenzie Client Alert, "*Multinational supply chains and intangible assets under the Australian Taxation Office's microscope*" distributed in November 2018.

By Tom Brennan, Sydney

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