Tax News and Developments

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In This Issue:

Proposed Regulations Under Code Section 385

The US Department of Treasury and the IRS recently issued proposed regulations under Code Section 385 (the "Proposed Regulations"), in parallel with, and on the same day as, the release of new final and temporary regulations under Code Section 7874. In light of the coordinated release of these two sets of guidance, many taxpayers and tax practitioners had initially assumed that the Proposed Regulations were targeted at earnings-stripping transactions arising in the context of inversions. That assumption was only partly correct. While the Proposed Regulations will certainly impact inverted companies and out-from-under planning, they apply equally to non-inverted foreign-based multinationals and US multinational companies as well.

If finalized in their current form, the Proposed Regulations would dramatically change the manner in which debt instruments are characterized for US federal income tax purposes by adding new reporting and documentation requirements and *per se* rules that would recharacterize debt (respected as such under general tax principles and compliant with the new documentation and reporting requirements) as stock in certain circumstances. As we note in a separate client alert, *Proposed Regulations Under Code Section 385* (April 19, 2016), the radical nature of the Proposed Regulations' departure from the traditional common law principles considered by Congress when it enacted section 385 make the regulations vulnerable to a validity challenge.

In broad strokes, the Proposed Regulations:

1. Impose extensive documentation and reporting requirements in connection with the issuance of certain intercompany debt instruments which, if not satisfied, result in the instrument being characterized as stock for US tax purposes (the "Documentation Requirements");

2. Allow the IRS to treat a portion of a debt instrument as stock, rather than as either entirely debt or entirely equity (the "Part Stock Rules"); and

3. Automatically treat certain intercompany debt instruments as stock if issued in connection with certain intercompany distributions, stock acquisitions, and asset reorganizations (the "General Rule"), or with a principal purpose of funding such a distribution, acquisition or reorganization (the "Funding Rule").

Significantly, the Documentation Requirements and the Funding Rule have the potential to recharacterize debt as stock based on facts and circumstances occurring long after the instrument was first issued and which have no bearing on the treatment and character of the instrument under general tax principles.

Upcoming Tax Events

- **Baker & McKenzie/TEI Software & E-Commerce Day**
  Redwood Shores, CA
  May 10, 2016
- **TEI Audits & Appeals Seminar**
  Santa Clara, CA
  May 17-19, 2016
- **Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference Series**

  Washington, DC
  June 8-9, 2016
  *Register with corporate guest code **BAKDC16***

  Toronto, Ontario
  August 29-30, 2016

  Hong Kong
  September 19-20, 2016
- **Baker & McKenzie/Bloomberg BNA International Tax Conference**

  Toronto, Ontario
  August 31, 2016

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

The proposed effective dates only further complicate these already complex rules. The Part Stock Rules and the Documentation Requirements only apply prospectively to debt instruments issued (or deemed issued) after the regulations become final. The General Rule and the Funding Rule, on the other hand, apply to any debt instrument issued (or deemed issued as a result of a significant modification) on or after April 4, 2016. Affected instruments, however, will not be recharacterized as stock under the General Rule or Funding Rule until 90 days after the date final regulations are issued. The preamble to the Proposed Regulations notes that Treasury "intends to move swiftly" to finalize the Proposed Regulations.

The Proposed Regulations and the potential implications for both US and foreign-based multinationals are discussed in greater detail in the North America Tax Client Alert, *Proposed Regulations Under Code Section 385*, distributed on April 19, 2016 and available under publications at www.bakermckenzie.com/tax. Baker & McKenzie is also preparing a client alert on the inversion regulations that were issued on the same day as the Proposed Regulations. The client alert, to be distributed shortly, will discuss the final and temporary regulations under section 7874 and other provisions affecting inverted companies. These regulations finalize, with some modifications, the rules previously announced in Notice 2014-52 and Notice 2015-79 that affect both inversion transactions and post-inversion planning. The regulations also introduce new limitations on inversions, including limitations on multiple-step acquisitions and serial acquisitions.

The Facts Matter: A Setback for Guidant

On February 29, 2016, Judge Laro of the US Tax Court, in a fully reviewed Tax Court Opinion, *Guidant LLC v. Commissioner*, 146 T.C. No. 5 (Feb. 29, 2016), denied the motion for partial summary judgment filed by Guidant LLC ("Guidant") in February 2015. Guidant had moved for partial summary judgment that the adjustments proposed by the Commissioner of Internal Revenue (the "Commissioner") were arbitrary, capricious and unreasonable as a matter of law, because (1) the Commissioner did not determine the "true separate taxable income" of each controlled taxpayer within the meaning of Treas. Reg. § 1.482-1(f)(1)(iv) and (2) the Commissioner did not make specific adjustments with respect to each separate transaction at issue involving an intangible, a purchase and sale of property, or a provision of services. In denying Guidant's motion for partial summary judgment, the Court held that (1) neither Code Section 482 nor the regulations thereunder require that the Commissioner, when exercising his authority under section 482, always determine the true separate taxable income of each controlled taxpayer in a consolidated group contemporaneously with the making of the resulting adjustments and (2) that section 482 and the regulations thereunder allow the Commissioner, when exercising his authority under section 482, to "aggregate" one or more related transactions instead of making specific adjustments with respect to each transaction.

The Court emphasized that its holdings were made only as a matter of law. In the summary judgment determination, the Court construed the facts in the light most favorable to the Commissioner. The Court made clear that it was ***not*** deciding whether the Commissioner's aggregation approach to its section 482 adjustments were arbitrary, capricious or unreasonable as a matter of ***fact***, which it found it could only decide with the benefit of a full factual record.

Products and Entities at Issue

Guidant's case involved four different product groups and two separate foreign manufacturing sites. Guidant's entities and products at issue included, in material part: (1) finished cardiac rhythm management ("CRM") devices, including pacemakers, implantable cardiac defibrillators, and cardiac resynchronization devices, as well as coronary stent delivery systems and standalone balloon catheters manufactured by Guidant's foreign manufacturing subsidiary in Ireland ("Guidant Ireland"); (2) hybrid components manufactured by both Guidant's domestic vertically integrated hybrid manufacturer and Guidant Ireland, depending on the taxable year at issue; and (3) CRM leads and certain balloon catheters, guidewires, aortic vascular prostheses and coronary artery bypass grafting surgery devices manufactured by Guidant's foreign manufacturing subsidiary in Puerto Rico ("Guidant Puerto Rico"). Guidant's US-based marketing and sales affiliate, Guidant Sales Corp. ("GSC"), sold and distributed to end users in the United States the medical devices that Guidant Ireland and Puerto Rico manufactured. Certain foreign Guidant distribution subsidiaries sold in many countries outside of the United States the medical devices manufactured by Guidant Ireland and Puerto Rico.

Controlled Transactions at Issue

Guidant's US-based entity Cardiac Pacemakers, Inc. ("CPI") owned intangible property related to CRM pulse generators and hybrids that it licensed to Guidant Ireland. CPI manufactured and sold CRM hybrids to Guidant Ireland, which then sold finished CRM devices to GSC and Advanced Cardiovascular Systems, Inc. ("ACS") for sale within the United States and to CPI for sale to independent third-party foreign distributors outside the United States.

CPI, further, owned intangible property related to CRM leads that it licensed to Guidant Puerto Rico. Guidant Puerto Rico then sold CRM leads that it manufactured to GSC and to CPI. CPI resold the Guidant Puerto Rico leads it purchased to Guidant foreign sales affiliates and to independent third-party foreign distributors. Guidant Puerto Rico also sold certain CRM leads that it manufactured to Guidant Ireland, which subsequently resold the Guidant Puerto Rico leads that it purchased to Guidant foreign sales affiliates and to independent third-party foreign distributors.

Guidant's US-based entity ACS owned intangible property related to Vascular Intervention ("VI") stents, stent delivery systems and angioplasty balloon catheters that it licensed to Guidant Ireland. Before Guidant Ireland gained VI product sterilization capabilities in 2004, Guidant Ireland sold all of the VI devices it manufactured to ACS. ACS then resold the Guidant Ireland VI devices it purchased and sterilized to GSC, to Guidant foreign sales affiliates, and to independent third-party foreign distributors. After Guidant Ireland gained VI product sterilization capabilities in 2004, Guidant Ireland not only continued selling its VI devices intended for the US market to ACS, but also sold its VI devices intended for foreign markets to Guidant foreign sales affiliates and to independent third-party foreign distributors.

Both ACS and certain other of Guidant's US-based entities licensed to Guidant Puerto Rico intangible property related to guidewires, aortic vascular prostheses and coronary artery bypass grafting surgery devices in exchange for royalties. Guidant Puerto Rico sold all of the guidewires, aortic vascular prostheses and coronary artery bypass grafting surgery devices that it manufactured to ACS, Endovascular Technologies, Inc. (“EVT”), and CardioThoracic Systems, Inc. (“CTS”), which each subsequently resold those products to either Guidant’s US-based marketing and sales affiliate, GSC (for sale within the United States), Guidant’s foreign sales affiliates, or independent third-party foreign distributors.

Notices of Deficiency

The Commissioner asserted deficiencies and accuracy-related penalties of approximately $3.5 billion for the years at issue. The Commissioner’s notices of deficiency attributed all the income reallocation to Guidant, as the parent company. None of the Commissioner’s notices of deficiency calculated or specified what, if any, amounts of the section 482 adjustments were attributable to CPI, ACS, EVT, CTS or GSC. Thus, the notices did not increase the income of the particular Guidant subsidiary that owned the intangible property licensed to the foreign manufacturers. In addition, the notices did not specify which of the controlled transactions were being adjusted. Instead, the notices simply calculated the adjustment based on a calculation of the profits of each foreign manufacturing company in the aggregate for all products manufactured at the location.

Reasoning and Holdings of the Court

Guidant’s First Argument – True Separate Taxable Income

Guidant first argued that the Commissioner’s adjustments were arbitrary, capricious and unreasonable as a matter of law because he failed to determine the true separate taxable income of ***each*** controlled taxpayer that engaged in the controlled transactions. Guidant argued, for example, that the increase in royalty income associated with its vascular products should be allocated to ACS, not Guidant, and, because the Commissioner did not do so, the notices of deficiency were arbitrary as a matter of law. The Commissioner, in response, asserted that the Commissioner need not determine each controlled taxpayer’s true separate taxable income and that, rather, the Commissioner must determine the affiliated group’s true combined taxable income. In the Commissioner’s view, the Commissioner should determine each controlled taxpayer’s true separate taxable income only to the extent that doing so would not interfere with the Commissioner’s ability to reliably determine taxable income from the controlled transactions underlying the section 482 adjustments.

In rejecting Guidant’s arguments, the Court observed that the Guidant group members and their foreign affiliates “performed numerous functions on behalf of its business unit and performed functions on behalf of other Guidant-group-related entities, including Guidant Ireland, Guidant Puerto Rico, GSC, and Guidant’s sales affiliates.” The Guidant group members, further, “each owned valuable intangibles relating to the development and manufacture of the products within their business units.” Thus, after considering these contributions that each Guidant group member made, the Court concluded that the fact that the Commissioner reached his own conclusion, in part, on the basis of the relationships between the Guidant group members and their foreign affiliates and on the alleged lack of documentation to make reliable adjustments was reasonable.

In reaching its holding, the Court pointed out that it did not hold that the Commissioner’s section 482 adjustments were not arbitrary, capricious or unreasonable as a matter of fact. The Court held only (as is appropriate in the context of a summary judgment motion) that these adjustments were not arbitrary, capricious or unreasonable as a matter of law, as section 482 and the regulations thereunder do not require that the Commissioner always determine the true separate taxable income of each controlled taxpayer in a consolidated group contemporaneously with the making of the resulting adjustments. Thus, the Court left open the possibility that Guidant might yet demonstrate that the Commissioner abused his discretion based on the evidentiary record built at trial.

Guidant's Second Argument - Aggregation

The Court next addressed Guidant's second argument, that the Commissioner's section 482 adjustments were arbitrary, capricious and unreasonable because they improperly "aggregated" all of the controlled transactions and did not make separate adjustments for each transfer of tangible property, transfer of intangible property, and provision of service.

In reaching its holding regarding Guidant's second argument, the Court again repeated that "section 482 gives the Commissioner broad discretion to allocate income between or among controlled enterprises in order to clearly reflect income or to prevent evasion of tax." In describing "the strength of the regulations," the Court quoted, inter alia, Treas. Reg. §§ 1.482-1(f)(2) and 1.482-1(f)(2)(i). Together, the regulations permit the Commissioner to aggregate two or more separate transactions to the extent that aggregation serves as the most reliable means of determining the arm's length consideration for the transactions and when, taken as a whole, the transactions are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions.

The Court disagreed with Guidant that, as a matter of law, the Commissioner may not aggregate separate transactions involving tangibles, intangibles or services, stating that the regulations allow the Commissioner to do so when it "provides the best means of determining the true taxable income of a controlled taxpayer." The Court then cited two examples contained in the Treasury Regulations, Treas. Reg. § 1.482-1(f)(2)(i)(B), Ex. 2 and 3, that it found persuasive in determining that the pricing of each separate transaction between a US parent and its controlled subsidiaries is not required in certain circumstances. Example 2 provides that such transactions may be aggregated where the "transactions are so interrelated that they are most reliably analyzed on an aggregate basis," while the Court inferred from Example 3 that "pricing of each separate transaction between the US parent and the three controlled subsidiaries is not required because the information to perform such separate transaction pricing would not be available from the more reliable controlled group comparable." The Court held that, even though the Commissioner aggregated transactions between different products -- as well as different functions -- aggregation was not per se arbitrary, capricious, and unreasonable as a matter of law. As the Court noted with regard to Guidant's first argument, however, the Court again noted that its holding was only as a matter of law and that the determination of whether the Commissioner did indeed abuse his discretion by aggregating the transactions was, ultimately, a question of fact that should be resolved on the basis of the trial record.

Trial is scheduled to begin in July 2016 before Judge Laro. Guidant will then have the opportunity to revisit its arguments based on the factual record created at trial and to then show both that the Commissioner's adjustments were arbitrary, capricious, and unreasonable and that its own pricing methodologies were in accordance with arm's length principles.

By Jenny A. Austin and Jason Dimopoulos, Chicago

IRS and Treasury Issue Temporary Regulations that Create More Ambiguity than Clarity on the CFTE Safe Harbor

On February 4, 2016, the IRS and Treasury issued temporary regulations (the “2016 Regulations”) on an existing safe harbor (the “safe harbor”) for determining whether a partnership’s allocation of creditable foreign tax expenditures (“CFTEs”) is in accordance with the partners’ interests in the partnership and therefore must be respected. The safe harbor was introduced in final regulations in 2006 (the “2006 Regulations”) and revised in temporary regulations in 2012 (the “2012 Regulations”). In the Preamble to the 2016 Regulations, the IRS and Treasury state that the 2016 Regulations are intended to “clarify” the application of the safe harbor for (i) Code Section 743(b) adjustments, (ii) the special rules for deductible allocations and nondeductible guaranteed payments, and (iii) inter-branch payments. Although the 2016 Regulations may clarify the treatment of section 743(b) adjustments, the effect of the 2016 Regulations relating to the last two items amount to a substantive change from the predecessor regulations.

Partners in a partnership generally have wide latitude in structuring their arrangement, including allocations of partnership items. In general, an agreed allocation of partnership items will be respected if the allocation has substantial economic effect (“SEE”). Allocations that do not have SEE must be in accordance with the partners’ interest in the partnership (“PIP”). The 2006 Regulations provide that allocations of CFTEs do not have SEE, and therefore allocations of CFTEs must be in accordance with PIP. In addition to the general facts and circumstance test that can always be used to determine PIP, the 2006 Regulations provide a safe harbor through which an allocation of CFTEs will be deemed to be in accordance with PIP if the CFTEs are allocated in proportion to the distributive shares of income to which the CFTEs relate. According to the Preamble to the 2016 Regulations, in order to apply the safe harbor, a partnership must (i) determine the CFTE categories, (ii) determine the net income in each CFTE category, and (iii) allocate the CFTEs to each category. Treas. Reg. § 1.704-1(b)(4)(viii) provides a series of mechanical rules for analyzing each step.

2016 Regulations

In the Preamble to the 2016 Regulations, the IRS and Treasury state that the 2016 Regulations provide guidance relating to the allocation of CFTEs that is necessary to improve the operation of the safe harbor.

Section 743(b) Adjustments

The 2006 Regulations are silent on whether an adjustment under section 743(b) is taken into account in determining the net income in a CFTE category. Section 743(b) adjustments arise from transfer of a partnership interest with a Code Section 754 election or substantial built-in loss in the partnership. Under the 2016 Regulations, section 743(b) adjustments are not taken into account for purposes of the safe harbor, unless the transferee partner is a partnership with a section 743(b) adjustment as a direct or indirect partner in a lower-tier partnership.

Special Rules for Determining Net Income in a CFTE Category

In general, the 2006 Regulations determine the net income in a CFTE category by considering only partnership items that are recognized for US federal income tax purposes. However, the 2006 Regulations also provide a series of special rules (the "special rules") that adjust the net income in a CFTE category to reflect the effect of certain items that are deductible under foreign law. *See* Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii). In particular, one of the special rules provides that net income in a CFTE category includes guaranteed payments under Code Section 707(c) to the extent the guaranteed payment is not deductible by the partnership under foreign law. Another special rule provides that income attributable to an activity shall not include an item of partnership income to the extent the allocation of such item of income (or payment thereof) results in a deduction under foreign law. Similarly, income attributable to an allocation deductible under foreign law as a result of the partner's status is excluded from net income in a CFTE category.

The 2016 Regulations make two substantive changes to the special rules. First, the 2016 Regulations narrow the scope of the special rules by removing an entire class of transactions from the scope of the special rule: allocations or payments that give rise to deductions under foreign law.

Second, the 2016 Regulations provide that if one or more foreign jurisdictions imposes a tax that results in deduction from its taxable base, such adjustments only apply with respect to CFTEs attributable to *that* tax for purposes of applying the safe harbor. The 2016 Regulations further provide specific rules for guaranteed payments, preferential allocations, and foreign law exclusions due to the status of a partner.

Inter-branch Payments

Under the 2006 Regulations, an "inter-branch payment" was defined as a payment between branches of the partnership (including disregarded entities) that the recipient was required to include in income. The special rule for allocations or payments that gave rise to a deduction under foreign law expressly did not apply to inter-branch payments as defined in the 2006 Regulations. Instead, the 2006 Regulations contained a separate rule providing that CFTEs imposed on such payments are allocated to the CFTE category that includes the items attributable to the relevant activities of the recipient branch (the "inter-branch payment rule"). The 2012 Regulations, which were promulgated as part of a regulatory package relating to foreign tax credit splitting events, removed the inter-branch payment rule, the definition of an inter-branch payment and the limiting language in the special rule.

The Preamble to the 2016 Regulations states that in the IRS and Treasury's view, the inter-branch payment rule was removed in 2012 because it allowed taxpayers to separate CFTEs from income. However, the Preamble to the 2016 Regulations acknowledges that taxpayers have taken the position that a disregarded payment that gives rise to a deduction under foreign law should be excluded from net income in a CFTE category under the special rule. In this regard, the 2016 Regulations now explicitly include a new provision in Treas. Reg. § 1.704-1(b)(3)(iv) stating that disregarded payments are not taken into account in determining the amount of net income attributable to an activity, although a special allocation of income used to make a disregarded payment may result in the subdivision of an activity into divisible parts. The 2016 Regulations also add two new examples, Examples 36 and 37, which are intended to illustrate the allocation and apportionment of CFTEs to CFTE categories in the case of "serial" disregarded payments.

In Example 37, A, B, and C form ABC, a partnership for US federal income tax purposes. ABC owns three entities, DEX, DEY, DEZ, organized as corporations in country X, Y, and Z, respectively, that are disregarded as separate entities for US federal income tax purposes. DEX operates business X in country X, DEY operates business Y in country Y, and DEZ operates business Z in country Z.

During 2016, DEX earns $100,000 royalty income from unrelated parties. Country X imposes a 30% tax on DEX's net income. DEX makes royalty payments of $90,000 during 2016 to DEY that are deductible in DEX for country X purposes and subject to a 10% withholding tax imposed in country X. DEY makes royalty payments of $80,000 during 2016 to DEZ. Country Y and Country Z do not impose income or withholding tax. DEX, DEY, and DEZ do not earn any other income in 2016. As a result of these payments, DEX has taxable income of $10,000 for country X purposes on which $3,000 of taxes are imposed, and DEY has $90,000 of income on which $9,000 country X withholding tax are imposed.

The ABC partnership agreement provides that the partners' allocations of partnership items respects the disregarded payments by attributing $10,000 to the business X activity, $10,000 to the business Y activity, and $80,000 to the business Z activity. To prevent separating CFTEs from related foreign income, Example 37 concludes that the $90,000 royalty payment from DEX to DEY and the subsequent $80,000 royalty payment from DEY to DEZ create special items of $10,000 and $80,000, respectively, that must be treated as "divisible parts" of the business X activity, and therefore, as separate activities. The divisible part of the business X activity attributed to the payment from DEX to DEY ($10,000) and the business Y activity ($0) are treated as a single CFTE category. The divisible part of the business X activity attributable to the payment from DEY to DEZ ($80,000) and the business Z activity ($0) are treated as a single CFTE category. Because the $9,000 withholding tax is split between the Y CFTE category and the Z CFTE category, those withholding taxes should be allocated on a pro rata basis with $1,000 withholding tax to the Y CFTE category and $8,000 withholding tax to the Z CFTE category.

At first glance, the simple illustration in Example 37 appears to match the CFTEs with the corresponding income that is recognized for US tax purposes. However, Example 37 fails to address the complexities of reconciling a gross basis tax, such as withholding tax, with a net income tax regime. For example, if DEZ makes a fourth payment of $60,000 to a related regarded entity, USP, say, as a platform contribution transaction under a cost sharing arrangement, the treatment of the $9,000 withholding tax is unclear. The partnership will have a total of $30,000 net income out of the total $90,000 gross income from which the $9,000 withholding tax arose. One option ("Alternative 1") is to keep the $80,000 in the Y CFTE category for purposes of applying the safe harbor, even though $60,000 of the $80,000 leaves DEY. In Alternative 1, the result would be the same as Example 37. Another option ("Alternative 2") is to remove the $60,000 from net income in the Y CFTE category and allocate $20,000 to the Y CFTE category. In Alternative 2, a pro rata distribution would result in allocation of $3,000 to the Y CFTE category and $6,000 to the Z CFTE category. These two possible methods arrive at very different results.

In sum, Example 37 does not consider the types of payments that should be removed, if at all, from net income in a CFTE category (*e.g.*, platform contribution transaction payment, cost sharing payment as a reimbursement of R&D costs, payment for R&D services, or a payment for management services).

Additionally, Example 37 fails to consider the effect of operating expenses of the disregarded entities, some of which may or may not be recognized for US tax purposes. In Example 37, the disregarded entities have no expenses recognized for US tax purposes. If DEZ has $70,000 in R&D expenses from salaries to R&D employees, it is unclear whether the Z CFTE category should still be allocated $80,000 of the $90,000 royalty payments when DEZ only has a net amount of $10,000.

This discussion is far from an exhaustive list of situations left unclear under Example 37.

Table - Allocation of Withholding Tax in Example 37 and Alternatives 1 & 2

	Total	DEX	DEY	DEZ	USP
Example 37					
Gross Income	90,000	0	10,000	80,000	
Income Ratio		0	1/9	8/9	
WHT (10%)	9,000	0	1,000	8,000	
Alternative 1 - $60,000 payment from DEZ to USP excluded					
Gross Income	90,000	0	10,000	20,000	60,000
Income Ratio		0	1/9	8/9	
WHT (10%)	9,000	0	1,000	8,000	
Alternative 2 - $60,000 payment from DEZ to USP included					
Gross Income	30,000	0	10,000	20,000	60,000
Income Ratio		0	1/3	2/3	
WHT (10%)	9,000	0	3,000	6,000	

Conclusion

The 2016 Regulations substantively change the special rules and the treatment of disregarded payments. Taxpayers with partnerships that have foreign operations, income and taxes should carefully consider how these changes may affect the partnership results. The examples in the 2016 Regulations will provide little guidance to taxpayers whose partnerships have real business operations.

By Erik J. Christenson, San Francisco and Michelle Ng, Palo Alto

As Taxpayers Increasingly Gamble and Docket in Tax Court to Get to IRS Appeals, LB&I Issues Revenue Procedure 2016-22 to Increase the House's Edge

On March 23, 2016, the IRS released Rev. Proc. 2016-22, 2016-15 I.R.B. 1, which further emboldens the Commissioner in denying taxpayers the right to go to IRS Appeals division after docketing their case in US Tax Court. Rev. Proc. 2016-22 applies to all cases docketed in US Tax Court pending on or after March 23, 2016, and supersedes its predecessor, Rev. Proc. 87-24, 1987-1 C.B. 720. Rev. Proc. 2016-22 is the IRS's latest attempt to stack the deck against taxpayers who seek to resolve significant tax disputes short of trial through allowing consideration by, and likely settlement with, the IRS Appeals division ("Appeals").

Appeals Faces More Challenges to Its Independence

Historically, taxpayers have been able to resolve the vast majority of unresolved audit issues at Appeals. Appeals' mission has been "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." Appeals' independence from other IRS divisions is, and should remain, at the core of its mission. Specifically, Appeals "must show itself to be objective, impartial, and neutral in fact as well as appearance." *See* www.irs.gov/Individuals/Appeals-An-Independent-Organization*.* Without fairness and impartiality, Appeals' value to the taxpayer as a legitimate path for settlement erodes, with more taxpayers instead proceeding directly to the courts.

In 2012, the IRS phased in the Appeals Judicial Approach and Culture ("AJAC") project. In AJAC, the IRS clawed back on Appeals' ability to investigate facts on its own. Instead, Appeals will return non-docketed cases to Exam when a taxpayer offers new information or raises a new issue that requires investigation or analysis. Further, AJAC has put a premium on Exam submitting a "complete" and "fully-developed" case to Appeals for consideration. Post-Protest information document requests ("IDRs") and witness interviews to further develop the "new" facts taxpayers raised in their Protests are more common.

When it launched Phase II of AJAC in July 2014, the IRS promised that additional changes related to post-docketed Appeals cases would be implemented. On October 15, 2015, Treasury and the IRS published Notice 2015-72, 2015-44 I.R.B., which proposed new procedures to update Rev. Proc. 87-24, 1981-1 C.B. 720. The IRS received three substantive comments to Notice 2015-72. In response, the IRS clarified ambiguous language in the new Rev. Proc., including how a taxpayer may opt out of post-docket consideration by Appeals. The IRS did not address taxpayer demands for clarifications for some of the more controversial parts of the Notice, but announced it would address several comments in the Internal Revenue Manual, Chief Counsel Directives Manual, or through agency training. Of course, none of this IRS guidance binds the IRS at the same, heightened level as a revenue procedure.

Rev. Proc. 2016-22 Covers LB&I in Post-Docket Appeals

Rev. Proc. 2016-22 contains three significant changes, each curtailing Appeals' ability to consider completely a docketed case.

First, Rev. Proc. 2016-22 precludes IRS Counsel from transferring cases designated for litigation to Appeals for post-docket consideration. While this is not a surprise, Rev. Proc. 2016-22 then states that IRS Counsel may avoid transferring a post-docketed case if Division Counsel or a higher level of Counsel believes that the transfer "is not in the interest of sound tax administration." The revenue procedure then offers an example of such a case, stating "[f]or example, Counsel may decide not to refer a docketed case to Appeals in cases involving a significant issue common to other cases in litigation for which it is important that the IRS maintain a consistent position."

Second, Rev. Proc. 2016-22 dictates that IRS Counsel will refer docketed cases to Appeals within 30 days of the case becoming at issue under Tax Ct. R. 38. As with the general rule, the IRS is quick to qualify this 30-day referral mandate. With manager approval, IRS Counsel may delay forwarding a case to Appeals if

Counsel has “a need for additional time.” An IRS Counsel executive must approve a delay of more than 90 days, and must explain to Appeals the reason for delay, and notify the taxpayer that referral is delayed.

This second change is not surprising when considering how IRS Counsel has approached these cases in the past. While Exam may have spent years developing an issue before it is docketed, IRS Counsel gets a fresh look. IRS Counsel may determine that the case is not sufficiently developed for Appeals, and issue discovery as the price of admission for Appeals to consider a case post-docketing. Discovery often is significant in terms of time, expense and resources for a taxpayer to complete and/or dispute.

Third, once it receives the case, Appeals has sole authority to resolve a docketed case through settlement until the case is returned to IRS Counsel. However, if IRS Counsel determines it needs the case for trial preparation, IRS Counsel can request that Appeals return the case, and all settlement authority, to IRS Counsel before Appeals completes considering the case. Under Rev. Proc. 87-24, Appeals may retain settlement authority over some or all issues upon mutual agreement with IRS Counsel.

The third change in Rev. Proc. 2016-22 is significant. While the revenue procedure appears to indicate that IRS Counsel should get the case to Appeals soon after it become at issue, it appears that IRS Counsel may use its “need” to prepare the case for trial as the hook to pull a case away from Appeals.

Unlike with non-docketed cases, Appeals cannot return a case back to Exam if a taxpayer raises new issues during Appeals discussions. In the post-docketed context, Appeals or IRS Counsel investigates the new issue. Exam is heavily consulted.

Finally, Appeals must return the case to IRS Counsel within 10 calendar days after the case appears on trial calendar. Appeals and IRS Counsel may mutually waive this requirement. This breaks from Appeals’ past practice where the case would informally remain with Appeals and discussions would continue long after the case was placed on trial calendar. With IRS Counsel holding sway over when a case appears on trial calendar, the 10 calendar day requirement may allow IRS Counsel to set a short fuse on otherwise pro-taxpayer discussions.

Should Taxpayers Continue to Place Their Bets on Resolving At Appeals?

Appeals remains the primary settlement forum for taxpayers’ disputes, but taxpayers should be aware of the increased efforts by the IRS to curb Appeals’ independence. This third phase of AJAC continues to assert control over Appeals by empowering IRS Counsel to end taxpayer discussions with Appeals and march toward trial. The stakes for taxpayers to ensure that a case is fully-developed, factually and legally, before going to Appeals are even higher in the post-docket context. Buying in to the game is the price of discovery, and now Rev. Proc. 2016-22 permits IRS Counsel to read Appeals, then pull back its chips and bet on the outcome of trial if Appeals signals it may not favor the IRS’s view of the case.

By Kristen B. Proschold, Houston and Robert Hammill, Palo Alto

Make Room for Tax Exempt and Government Entities: Rev. Proc. 2016-19 Expands the IRS's Industry Issue Resolution Program

Rev. Proc. 2016-19 ("the Rev. Proc."), issued by the IRS on March 4, 2016 and effective as of April 25, 2016, expands the IRS's Industry Issue Resolution ("IIR") Program, first introduced by the IRS in Notice 2000-65. Previous guidance issued by the IRS in Rev. Proc. 2003-36 limited IIR Program submissions to those entities under the jurisdiction of the IRS's Large Business & International ("LB&I") (formerly Large and Mid-Size Business) and Small Business and Self Employed ("SB/SE") Operating Divisions. The Rev. Proc. supersedes Rev. Proc. 2003-36 and extends the IIR Program to entities under the jurisdiction of the Tax Exempt and Government Entities ("TE/GE") Operating Division, in addition to the LB&I and SB/SE Operating Divisions. The Rev. Proc. also updates the submission procedures previously outlined in Rev. Proc. 2003-36.

The objective of the IIR Program is to identify and resolve frequently disputed and burdensome tax issues that are common to a large number of taxpayers through pre-filing guidance rather than post-filing examination.

The Rev. Proc. presents a list of characteristics that issues submitted for consideration under the IIR Program should have. For an issue to be appropriate for consideration under the IIR Program it should have two or more of the following characteristics:

1. The proper tax treatment of a common factual situation is uncertain;
2. The uncertainty of the treatment results in frequent and repetitive examinations of the same issue;
3. The frequent and repetitive examinations require significant resources from both the impacted entity and the IRS;
4. The issue is significant and impacts a large number of entities;
5. The issue requires an extensive amount of factual development; and
6. Collaboration would facilitate a proper resolution of the tax issues by promoting an understanding of entities' views and business practices.

Notice 2005-59 provides further criteria for evaluating proposed IIR Program issues relating to accountable plans, which are incorporated into the Rev. Proc. by reference.

Issues that the IRS generally believes are not appropriate for consideration under the IIR Program are those that are unique to one or a small number of entities, those that do not fall under the jurisdiction of the LB&I, SB/SE or TE/GE Operating Divisions, those that involve transactions lacking a bona fide business purpose or that have a significant purpose of improperly reducing or avoiding federal taxes and those that involve transfer pricing or international tax treaties.

A requester under the IIR Program should be an organization or group of entities that represents a significant number and cross section of the entities faced with the particular tax issue or issues discussed in the request. For example, the Rev. Proc. provides that a retail industry group that represents both large nationwide retailers as well as independent retailers might make a request through the IIR program to resolve a Code Section 263(a) capitalization issue common to all member retailers. An IIR request can be submitted at any time of the year and an IRS representative will notify the requester when the IRS has decided to either select or reject the IIR request. The IRS will make public, at least once per year, all IIR Program requests received, as well as those that were selected.

All IIR program submissions should be submitted to the IRS via e-mail. There is no particular format in which a request should be submitted; however, the request should include an statement of the issue, a description of why the issue is appropriate for the IIR Program, an explanation of the need for guidance on the issue, an estimate of the number of entities affected by the issue and how the request relates to those entities and the contact information of an individual to contact should the IRS require more information. The submission may also include the requester's recommendation as to how the issue should be resolved.

If a request is selected, the IRS will establish an IIR team to analyze the issues and develop the appropriate guidance. The IIR team will include both personnel from the requester and from the IRS. If the requester does not provide appropriate personnel to participate as IIR team members, the issue may not be selected for the IIR Program. Once a team has been established, the team undertakes a collaborative effort to address the issues in a manner that addresses the concerns and goals of the team members and enhances good tax administration. Resolution of an IIR Program request will require multiple exchanges of information, which could included books and records of specific taxpayers. The Rev. Proc. provides, however, that because the presentation of specific taxpayer information is not undertaken for the purpose of examination or inspection within the meaning of Code Section 7605(b), the information provided in the context of the IIR Program will not constitute information furnished as part of an examination or inspection within the meaning of section 7605(b). All IIR Program requests and additional information provided pursuant to a request are subject to FOIA, and therefore should not include confidential or taxpayer specific information that is not intended to be disclosed.

Selected IIR Program requests may result in published guidance, such as a regulation, revenue ruling, revenue procedure or notice. The request could also result in new or revised administrative procedures such as a new operating directive or a revision to an Internal Revenue Manual provision.

By Amir-Kia Waxman, New York

2015 IRS APA Annual Report: Increased Demand and Challenges Ahead

On March 31, 2016, the IRS issued its Annual Report Concerning Advance Pricing Agreements (Announcement 2016-12, 2016-16 I.R.B. 1) ("2015 APA Report"), which presents the key results of the Advance Pricing and Mutual Agreement Office ("APMA"). The 2015 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 taxpayers involved, industries covered and transfer pricing methods ("TPMs") employed. The following summarizes the highlights of the report and provides observations on APMA and APAs, both from within the program and as a taxpayer advisor.

APMA Operations

APMA staffing in 2015 remained stable compared with the prior year, with 83 team leaders and economists and 10 senior managers. The IRS previously stated that it intended to increase APMA's staffing to approximately 65 team leaders (up from 62 for CY 2015) and 30 economists (up from 21 for CY 2015) to improve its case processing times, but IRS budget issues have resulted in an overall hiring freeze at the agency that puts those planned increases at risk. Further, significant changes in leadership continued during 2015, with turnover at the Deputy Commissioner (International) and the Transfer Pricing Operations Director positions, as well as the restructuring of the IRS Large Business & International Division that "stood up" in February 2016. The disruption caused by management turnover and the then-impending restructuring, in addition to resource demands from the OECD-G20's Base Erosion and Profit Shifting ("BEPS") project, likely had an impact on internal operations, APA negotiations with taxpayers and bilateral APA negotiations involving other countries' tax authorities, thereby requiring additional time to process certain types of APAs, as discussed below.

APA Intake and Output

New applications

APA filings spiked in 2015, increasing nearly 70% from 2014 (183 complete applications in 2015 vs. 108 in 2014). The sharp increase in APA submissions is likely attributable to taxpayers accelerating their filings to avoid the application of the new revenue procedure governing APAs that was issued by the IRS in August 2015 and that went fully into effect on December 30, 2015. Another factor that could have contributed to the uptick was the release in 2015 of the final reports under the OECD-G20's BEPS project, which many companies perceive as creating uncertainty that can be mitigated by seeking the certainty of an APA. It is expected that, in 2016, the number of submissions could further increase as a result of opening up a program with India, and APMA management has indicated an intention to target more completions in 2016 as a result of that new work stream.

With the spike in APA requests and only a modest increase in executed APAs, pending APAs swelled to 410 in 2015 compared with 336 in 2014, an increase of 22%. The increase in pending APAs reflects a 37% increase in the volume of pending unilateral APAs and an 18% increase in pending bilateral APAs. In addition, bilateral renewal APAs continue to constitute the lion's share of pending renewal APAs: 78% of pending renewal APAs in 2015 were bilateral, compared with 80% in 2014.

In terms of the countries for which bilateral requests are filed, the 2015 APA Report shows that, as in prior years, bilateral requests involving Japan and Canada predominate (56% of the total bilateral requests), a slight percentage increase from 2014 (53%). In 2015, five other countries (Germany, Korea, United Kingdom, Australia and China) each represented at least 4% of the bilateral submissions, with 14% coming from all other countries combined. The IRS also announced its first bilateral APA executed with Italy and recently began accepting bilateral APA requests involving India. This diversification of participation is an encouraging sign for multinational companies doing business around the globe, in that as bilateral APA relationships between countries increase and improve, it expands the potential for companies to resolve transfer pricing issues.

Another notable statistic regarding applications involves unilateral submissions. The percentage of unilateral submissions remained steady with 2014 at 29% of the total, as compared to 18% in 2013 (and 19% in 2012). The increase after 2013 could reflect BEPS concerns and the heightened focus on transfer pricing by all of the US treaty partners, including those that do not have an APA program or indicate more cross border activity with countries with which the United States does not have a treaty, e.g., Brazil and Singapore.

Processing times

For APAs executed in 2015, average processing times decreased significantly for unilateral APA renewals from more than 3 years in 2014 to less than 2 years. The IRS also processed new bilateral APAs somewhat faster in 2015 (approximately 40 months instead of 44 months), but processing times continued to plague bilateral APA renewals, which required, on average, approximately 42 months compared with 36 months in 2014.

Executed APAs

With relatively stable staffing, the IRS executed approximately 9% more APAs in 2015 (110 APAs; 72% bilateral) as compared with 2014 (101 APAs; 80% bilateral). Of those APAs, 60% of both the unilateral and bilateral agreements involved renewals, up from 47% in 2014.

As in prior years, the 2015 APA Report indicates that US-Japan bilateral APAs continue to constitute the largest percentage of overall APAs that the program processes, but the number of US-Japan bilateral APAs executed is down relatively significantly compared with 2013. That is, 46% of the 80 executed bilateral APAs during 2015 were US-Japan bilateral APAs (i.e., 37 executed APAs), compared with 38 in 2014 and 56 in 2013. The heavy caseload involving US-Japan APAs is reflected in the number of APA teams that have responsibility for the US-Japan APAs: three 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 (as well as other jurisdictions). The number of executed bilateral APAs involving Canada increased from 12 to 18 in 2015, and the UK dropped from 8 to 3 or fewer.

The IRS continues to devote a substantial portion of its resources to APAs involving Japan and Canada, but the backlog for such APAs, particularly with Japan, persists. The reasons for the backlog are varied, but the Japan case status can be contrasted with APAs submitted under the US-Canada treaty, where the treaty authorizes APAs that are unagreed for two years after the exchange of positions to be subject to arbitration. In contrast, until the proposed US-Japan treaty protocol, which includes arbitration, is signed, it may be difficult to accelerate agreements between the United States and Japan. In addition, it appears that new levels of review of APA requests and draft APA agreements may be contributing to longer processing times.

Withdrawn APA requests

Taxpayers withdrew 10 APAs in 2015, which is significantly more than in 2014 (one withdrawal), but it appears to be only slightly higher than the historical average. Similar to 2014, the IRS did not cancel nor revoke any APAs in 2015.

US vs. Non-US parent companies

An even larger percentage of the APAs executed in 2015 involved non-US parent companies; 64% of the executed APAs for 2015 involved non-US parent companies and their US subsidiaries, while only 18% involved US parent companies and their non-US subsidiaries. In 2014, the split was 55%:31% (or 55%:29% including US companies with non-US branches). The ongoing appeal of the IRS APMA program to non-US parent companies could be due to, among other things, the IRS's continued focus on transfer pricing involving non-US parent companies, non-US parent companies' desire for transfer pricing certainty, or an increase in audit activity in other countries that a bilateral APA with the United States could mitigate.

Industries represented

Consistent with the 2014 results, most of the agreements involved predominantly manufacturing, but agreements involving wholesale/retail trade jumped from 22% in 2014 to 35% in 2015. Within the manufacturing segment, computer and electronic equipment represented almost a quarter of those agreements in 2015, followed by the chemical and transportation equipment industries. In contrast, the transportation industry was not separately stated in 2014, implying that three or fewer APAs were executed as compared with seven APAs in 2015. 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 which specific cases reach resolution at what time. The other industry classification that is prominent in the APA program is wholesale/retail trade, and wholesalers of durable goods dominate that class year over year, with more than 50% of the total APAs in that category for all three years for which data is available. The number of APAs for wholesalers of durable goods doubled from 14 APAs in 2014 to 28 in 2015.

TPMs applied

For 2015, the comparable profits method/transactional net margin method ("CPM/TNMM") was the most commonly applied TPM for tangible and intangible property transactions (applied to 79% of such transactions, which is approximately the same as in 2014), followed by the comparable unrelated transactions ("CUT") method (11% of transactions in 2015 vs. 13% in 2014). 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 less frequently than in 2014: it dropped to 62% of the cases (vs. 88% in 2014). In contrast, the Berry ratio PLI climbed to 25% of the cases (vs. 6% in 2014).

For services transactions, PLIs under the CPM/TNMM shifted away from the Operating Margin as well in 2015. In 2014, the Operating Margin was the most common PLI (47% of cases), followed by the Operating Profit to Total Services Cost (45%) and then the Berry ratio (8%). In 2015, 55% of the cases applied the Mark up on Costs, followed by 32% for the Operating Margin and 13% for the Berry ratio.

Asset intensity adjustments

It is the policy of the 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 where such an adjustment is made in any given year is a function of the specific facts of the cases that were resolved in that year.

APA terms

APA term lengths, including rollback years, returned to the 2013 level of an average of seven years, an increase from the 2014 average of six years. The largest number of APAs are executed with five-year terms (36% of the total). The return to a longer average term in 2015 could signal a trend as APMA continues to work through the older cases that built up in inventory in recent years. These cases appear to continue to skew both the average and the absolute term lengths of executed APAs. In 2015, more than 11 APAs had terms of 10 years or longer, compared with approximately 6-8 APAs for 2014. In addition to the impact of aging inventory, the longer 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 taxpayers and governments often seek to extend the term of an APA and provide some prospectivity.

FX adjustments

The APA program has no set policy regarding adjustments to taxpayer financials to account for currency fluctuations. The 2015 APA Report notes in that regard "In appropriate cases, APAs may provide specific approaches for dealing with currency risk, such as adjustment mechanisms and/or critical assumptions." Over the years of the APA program, FX-adjustment mechanisms have been proposed by taxpayers 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

Both positive trends and areas for concern are reflected in the 2015 APA Report, requiring attention for companies in the APA program and those considering entering the program. On the positive side, the number of executed agreements remains strong, staffing numbers are stable, processing times for certain types of APAs decreased and APAs are being executed between a larger number of jurisdictions. As the IRS gains more experience with other treaty partners, particularly India, this expands the opportunity for US-based taxpayers to manage their transfer pricing risk through multiple bilateral agreements. It is also a positive development that, despite the continued prominence of the CPM/TNMM and Operating Margin PLI, the IRS appears willing to agree to apply a variety of transfer pricing methods in its agreements, showing flexibility to select the "best method" for the covered transactions.

Formidable challenges, however, are here now and are on the horizon. It is unknown whether the IRS APMA program is capable of processing a record number of APA requests in 2015 and working through its aging inventory with its current level of resources. APA demand is projected to continue to increase with the desire for certainty, BEPS pressures, the restructuring of IRS LB&I, the increased number of treaty partners implementing APA programs (including both India and Ireland) and other factors.

By Richard L. Slowinski and Barbara Mantegani, Washington, DC

New Tax Breaks for US Taxpayers Operating and Investing in Cuba

On March 1, 2016, the IRS issued Revenue Ruling 2016-8, 2016-11 I.R.B. 426, announcing that taxpayers are eligible to claim US foreign tax credits for creditable Cuban taxes paid, and that income earned in Cuba would no longer automatically be treated as Subpart F income. The ruling has retroactive effect on transactions that occurred after December 21, 2015. The ruling specified that the Secretary of State certified to the Secretary of Treasury that Cuba no longer met the definition in Code Section 901(j)(2)(A) (discussed below). The Secretary of State's certification is likely attributable to the restoration of the United States' diplomatic relations with Cuba. The ruling modified Revenue Ruling 2005-3, 2005-3, I.R.B. 334, which provides a list of certain black list countries subject to special rules under Code Sections 901(j) and 952(a)(5). However, while Revenue Ruling 2016-8 modified the 2005 ruling's effect on Cuba as it relates to sections 901(j) and 952(a)(5), it did not reverse the Code Section 911(d)(8) limitation that applies to the foreign earned income exclusion under Code Section 911(a) for US individual taxpayers living and working in Cuba.

Code Sections 901, 902, and 960 generally allow US taxpayers to claim against their US income tax liability, a foreign income tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued) to any foreign country or to any possession of the United States. However, the foreign income tax credit is subject to numerous limitations under section 901. One of these limitations is section 901(j), which denies credits for foreign income taxes paid or accrued (or deemed paid or accrued) to certain countries that the United States does not recognize, does not conduct diplomatic relations with, or has severed diplomatic relations with because of acts such as terrorism or communism. Before the issuance of Revenue Ruling 2016-8, the IRS included Cuba on the list of countries in which taxes paid were not creditable under section 901(j). *See* Rev. Rul. 2005-3 (still in effect). Revenue Ruling 2016-8 modifies Revenue Ruling 2005-3 by removing Cuba from the list of covered countries under Section 901(j), and permits taxpayers to claim US foreign tax credits for creditable taxes paid in Cuba.

Revenue Ruling 2016-8 also modified the Subpart F rules with respect to Cuba. Under Subpart F of the Code, certain types of income earned by a "controlled foreign corporation" ("CFC") are taxable to the CFC's US shareholders in the year earned, even if the CFC does not distribute the income to its shareholders in that year. Subpart F operates by treating the shareholders as if they had actually received the income from the CFC. The income of a CFC that is currently taxable to its US. shareholders under the Subpart F rules is referred to as "Subpart F income." Section 952(a)(5) provides that the term "Subpart F income" means, in the case of any controlled foreign corporation, the sum of the income of such corporation derived from any foreign country during any period during which section 901(j) applies to such foreign country. Because the section 901(j) restriction previously applied to Cuba, it also caused Section 952(a)(5) to apply to treat any Cuban income earned by a CFC to be Subpart F Income. *See* Rev. Rul. 2005-3. However, as a result of the issuance of Revenue Ruling 2016-8 and the removal of the section 901(j) restriction on Cuba, section 952(a)(5) also no longer applies to treat Cuban income earned by a CFC to be subpart F income.

As noted above, Revenue Ruling 2016-8 did not mention the removal of the section 911(d)(8) limitation on foreign earned income exclusion as it relates to income earned in Cuba. Under the foreign earned income exclusion, US individual taxpayers may be entitled to exclude an amount of up to $101,300 (for 2016, adjusted annually for inflation) in eligible foreign earned income from their taxable income for US federal income tax purposes related to wages, salaries, professional fees or compensation, plus certain housing costs, provided they are either: (1) a bona fide resident of the foreign country for the entire taxable year, or (2) present in the foreign country or any other foreign country for a period of 330 days over any 12 month period. Sections 911(b)(2)(D), (d); Notice 2016-21, 2016-12 I.R.B. 465. The foreign earned income exclusion does not apply to amounts earned in "restricted" countries. Generally, section 911(d)(8)(A) provides that if travel with respect to any foreign country (or any transaction in connection with such travel) is proscribed by certain regulations during any period, then: (1) foreign earned income does not include income from sources within that country attributable to services performed during that period; (2) housing expenses do not include any expenses allocable to such period for housing in that country, or for housing of the taxpayer's spouse or dependents in another country while the taxpayer is present in that country; and (3) an individual is not treated as a bona fide resident of, or as present in, a foreign country for any day during which the individual was present in that country. Restricted countries are generally countries where travel by US citizens and residents is prohibited by regulations issued under the Trading With the Enemy Act or the International Emergency Economic Powers Act. According to the IRS's most recent listing, Cuba is listed as the last remaining country covered by this limitation. Rev. Rul. 92-63, 1992-2 CB 195 (as of August 17, 1992); Rev. Rul. 2005-3; Instructions for Form 2555 (Nov. 19, 2015). This restriction may be lifted, however, if the taxpayer falls with an exception to the prohibition. For example, American individuals may be lawfully present in Cuba to visit close family members, to engage in journalistic activity, or to perform research. In these instances, the individual should not lose tax benefits for travel to Cuba if the individual is engaging in transactions that are not in violation of the law. In Notice 2006-84, the IRS provided a small carve out for US individuals that earned income from performing services at the US Naval Base at Guantanamo, by allowing them to claim the foreign earned income exclusion and be exempted from the limitation under section 911(d)(8)(A).

Yet, it remains unclear why the IRS modified Revenue Ruling 2005-3 as it relates to sections 901(j) and 952(a)(5), but not section 911(d)(8), especially when there has been a restoration of the United States' diplomatic relations with Cuba. Only time will tell whether the IRS will issue future guidance on the removal of the section 911(d)(8) limitation on the foreign earned income exclusion for U.S. individuals living and earning income in Cuba. In light of Revenue Ruling 2016-8, it appears that further action is foreseeable.

By Michael J. Bruno, Miami

New Luxembourg Tax Proposals More Careful than Bold

In an interview with the Financial Times published on December 1, 2015, the Luxembourg finance minister said that the Grand Duchy was preparing to cut its headline tax rate in a package of reforms scheduled for 2017 that would reflect the international crackdown on "base erosion and profit shifting" ("BEPS"). He furthermore said: "If we want to remain competitive, we have to reduce nominal taxation because the base will become larger."

However, he signaled that the tax rates imposed on companies in Luxembourg would not be as low as Ireland's 12.5% corporate tax rate, stating: "Taxation is not all a company has to look at. If [the effective tax rate is] a couple of points beyond Ireland, we can be attractive." The expectations of many were that Luxembourg would reduce its global corporate headline tax rate to somewhere between 15% and 20%.

Subsequently the Luxembourg government, on February 29th, released the main proposals of the envisaged tax reform, which should enter into force in January 2017. On April 21st the finance minister gave further clarifications and announced some changes to the envisaged tax reform. The proposals most relevant for international investors are:

- A progressive reduction of the corporate income tax rate from 21% to 19% effective in 2017, and then to 18% effective in 2018. This reduction would result in a maximum aggregate income tax rate of 27.08% in 2017 and 26.01% in 2017, i.e., inclusive of the new corporate income tax rate, the 6.75% municipal business tax rate (for companies established in Luxembourg city) and the 7% solidarity surcharge. However, in a recent April 21st speech, the Minister of Finance stated that Luxembourg will observe very closely the international changes and especially the implementation of BEPS measures within the EU. According to the Minister, if required, Luxembourg will, after consultation with the industry, adopt further measures that will comply with international and European standards while making certain to have a "level playing field" with other countries.

- Luxembourg currently allows unlimited carry forward and use of tax losses. Starting in 2017 onwards, the use of newly generated tax losses may be limited in time and other limitations may apply. Based on a speech from the Minister of Finance in February, it was understood that the carry forward could be limited to 10 years, and the yearly use of the losses may be limited to 80%. In his April 21st speech, the Minister of Finance stated that they now intend to limit the carry forward of the newly generated losses to 17 years and that the yearly use of this new losses is limited to 75%.

- The minimum net wealth tax for Luxembourg companies investing more than 90% of their total balance sheet in financial assets (including transferable securities, loans, bank deposits) (so called Société de Participation Financières ("SOPARFIs")) for an amount exceeding €350,000, would be increased from €3210 (the current rate) to €4815 (inclusive of the 7% solidarity surcharge).

Overall, the tax reform proposals do not so much favor corporations, but rather individuals who are part of the so called "middle class." This class represents a vast majority of the people who may possibly reelect the existing government.

While the business community usually welcomes a Luxembourg tax reform with applause (as changes are generally business friendly), the tenor of comments this time was disappointment. As an example, the March 4th Bloomberg BNA Daily Tax Report used as a headliner: "Luxembourg's leading banking and business groups called corporate tax proposals announced earlier in the week 'poisonous' to foreign investment and called for the government to rethink the proposal to avoid damaging the economy." Tax experts and business representatives also criticized the proposed changes in the local press.

Indeed the announced headline tax rates of 27% and 26% are far above the tax rates applicable in Ireland and announced in the United Kingdom and Switzerland. On the other hand, because of leveraging, dividend and capital gains exemptions, tax credits, etc., the effective tax rate of a Luxembourg company is often between 18% and 12% or even lower. Hence, from a cash flow perspective, the Luxembourg effective tax rate is not so high.

In the current global environment (and especially in Europe), successful businesses that create jobs and invent things often are perceived as making too much money and not paying enough in taxes. Luxembourg as a country has also drawn scrutiny from journalists and some politicians for issuing rulings confirming relevant tax treatments. Such advance tax agreements are now less favored than a plain vanilla low tax rate. Furthermore, being very stable and pragmatic may no longer be enough to be considered as business friendly and a place where one may want to invest. This is the message that Luxembourg tax experts are voicing in their articles.

However, although the announced future headline tax rate is high compared to countries like Ireland, the United Kingdom and Switzerland, Luxembourg could choose to further reduce these rates. As stated by the Minister of Finance, the Luxembourg government may be observing what happens in other countries and which BEPS measures the relevant countries will implement, before making further proposals. While this may be an appropriate strategy, Luxembourg may not want to observe too long. Many experts predict that a drastic reduction in the headline rates would generate more tax income than less.

The proposal related to limiting use of loss carry forwards generated after January 1, 2017, is similar to rules that many countries have. However, Luxembourg is home to many alternative investment structures, such as private equity funds. The investments alternative investment managers make can often suffer losses in a given year leading to loss carry forwards. A reversal of such losses in later years constitutes taxable income, which would lead to an effective tax burden if the loss carry forward were not fully available. Under the new proposal, only relatively complex rules (with related compliance burdens) would avoid tax liability on investments that were overall not profitable but merely changed in value over the years. This is true not only for the alternative investment industry but for every holding, financing and investment company. Hence the question arises whether it is really worthwhile to introduce rules that would limit the loss carry forward.

Finally, increasing the minimum net wealth tax for SOPARFIs by €1,600 Euros to €4,815 may seem a minor increase. However, some investment managers have a very large amount of SOPARFIs, so the overall effect could be substantial and discourage investment in Luxembourg. It remains to be seen whether the government will stick to this proposal.

The Luxembourg government has had to navigate through rough waters in the last two years. Luxembourg has a reputation for being stable and business-friendly. As many countries, it will have to adapt furthermore to the quickly evolving international tax environment. The new tax proposals, however, seem in the eyes of many experts not to be the adequate measures yet, and it should be expected that further important changes will come in the near and medium term.

By Andre Pesch, Luxembourg

IRS LB&I Division Develops International Practice Units

As part of its ongoing strategy to improve knowledge and resource management, the IRS Large Business and International ("LB&I") Division has developed a series of International Practice Units ("Practice Units"), intended as a standardized guideline to aid agents in approaching a variety of international tax and transfer pricing issues. On August 17, 2012, the LB&I Commissioner announced plans to adopt an approach that would aim to "provide LB&I examiners clear and timely guidance on how to address issues; promote collaboration among LB&I employees; increase accountability in the resolution of issues; and enable robust lines of communication with taxpayers." LB&I Directive, LB&I-4-0812-010 (Aug. 17, 2012). To that end, LB&I established International Practice Networks ("IPNs"), a knowledge management network intended to provide exam teams with technical advice to help them manage examinations efficiently, consistently, and with technical proficiency.

A little over two years after IPNs were established, LB&I published its first batch of Practice Units. The Practice Units provide IRS examiners with materials that explain a variety of international tax concepts, transactions, and issues, and identify the resources and questions that examiners should ask while probing those issues. They are also intended to improve engagement with taxpayers. "When the agent has a full strategic picture of the transaction, they ask the right questions, which is good for the agent and the taxpayer," according to former LB&I Deputy Commissioner (International) Michael Danilack. Amy S. Elliott, Tax Analysts Exclusive: Danilack Reflects on Time at LB&I, 2015 TNT 8-1 (Jan. 13, 2015).

Since releasing the first batch in December 2014, LB&I has published 113 Practice Units, and more are expected to come. All published Practice Units are available at https://www.irs.gov/Businesses/Corporations/International-Practice-Units. Practice Units are expected to evolve as the compliance environment changes and new insights and experiences are contributed. The aforementioned website invites the public to review the Practice Units and provide feedback.

Practice Units are not official pronouncements of law or directives and cannot be used, cited or relied upon as such. They are not meant to be a comprehensive discussion of all pertinent issues, law or the IRS's interpretation of current law. Practice Units do not limit an IRS examiner's ability to use other approaches when examining issues.

Practice Units provide taxpayers and practitioners a level of transparency in preparing for examinations. They identify areas of strategic importance to the IRS, provide insight into how examiners will approach various transactions, and can provide an understanding of the context in which an examiner will approach a particular issue or transaction.

By Bryan Koorstad, Chicago

States on the Verge of a Nexus Showdown

On February 22, 2016, the US Court of Appeals for the 10^{th} Circuit ("Tenth Circuit") upheld the constitutionality of Colorado's use tax notice and reporting requirements imposed on out-of-state retailers in Colo. Rev. Stat. § 39-21-112(3.5) and the regulations thereunder (collectively the "Colorado Law"). *Direct Marketing Association v. Brohl*, Dkt. 12-1175 (10^{th} Cir. 2016) ("*DMA I*"). The Direct Marketing Association ("DMA"), an industry group of businesses and organizations that market products via catalogs, advertisements, broadcast media and the Internet, challenged the Colorado Law, claiming that the notice and reporting requirements violated the Commerce Clause by discriminating against out-of-state retailers and unduly burdening interstate commerce. The Tenth Circuit found that the Colorado Law does not violate the Commerce Clause on either ground. The court also held that the bright-line physical presence nexus standard established by the US Supreme Court in *Quill v. North Dakota*, 504 U.S. 298 (1992), only applies to sales and use tax collection and not to the use tax notice and reporting requirements imposed by the Colorado Law, meaning that such requirements of the Colorado Law could be imposed on retailers without a physical presence in Colorado.

Assuming an appeal of *DMA I* is forthcoming, if this decision was ultimately upheld, the sales and use tax landscape would be anticipated to shift dramatically, as other states would likely enact similar use tax notice and reporting laws designed to significantly increase use tax compliance. But even if that were the case, the impact to taxpayers would likely pale in comparison to the effect of actually overturning *Quill* and allowing states to impose sales and use taxes on companies without an in-state physical presence.

Although the substantive matter before the Tenth Circuit in *DMA I* does not seek to overturn *Quill*, an earlier review by the U.S. Supreme Court, relating to the inapplicability of the Tax Injunction Act to the federal district court review of the Colorado Law, has raised the issue as a possibility. *Direct Marketing Association v. Brohl*, Dkt. 13-1032 (U.S. 2015) ("*DMA II*"). For a further discussion, please see prior *Tax News and Developments* article, *US Supreme Court Grants Certiorari in Direct Marketing Association* (Vol. XIV, Issue 4, August 2014). Specifically, Justice Kennedy's concurrence to *DMA II* advocates for a review of *Quill*, stating, "Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. . . . [*Quill*] should be left in place only if a powerful showing can be made that its rationale is still correct." Some states, namely Alabama and South Dakota to date, have recently taken action to challenge the physical presence standard itself and make this precise reconsideration of the physical presence nexus standard seemingly inevitable.

To further appreciate these implications, the following is a high-level summary of *DMA I*, and the actions taken by Alabama and South Dakota in reaction to *DMA II*.

The Colorado Law: Colorado's Use Tax Notice and Reporting Requirements

The Colorado Law requires retailers that do not collect Colorado sales tax and that have at least $100,000 of gross sales in Colorado ("Remote Sellers") to:

- Notify their Colorado customers that Colorado sales or use tax is due on all purchases that are not exempt from sales tax;
- Provide an annual purchase summary to each of their Colorado customers who spent more than $500 in the previous calendar year; and
- Provide an annual customer information report to the Colorado Department of Revenue ("Department") that details each of the retailer's Colorado customers and the total amount of their purchases.

The Colorado Law also provides for the imposition of penalties on non-compliant Remote Sellers.

DMA I: The Colorado Law Does Not Discriminate Against Interstate Commerce

The Tenth Circuit held that DMA did not carry its burden of showing that the Colorado Law: (1) was discriminatory on its face against out-of-state retailers; or (2) had a discriminatory effect of favoring in-state economic interests over out-of-state interests.

The Tenth Circuit found that the Colorado Law is not facially discriminatory because it does not explicitly distinguish between in-state and out-of-state economic interests. Rather, the statute "distinguishes between those entities that collect Colorado sales tax and those that do not." Absent statutory language that explicitly identifies geographic distinctions, the court held that a statute does not discriminate on its face.

The court further concluded that DMA failed to meet its burden of showing that the Colorado Law has a discriminatory effect on interstate commerce because the Colorado Law does not "alter the competitive balance between in-state and out-of-state firms." DMA failed to prove that the Colorado Law benefits local actors to the detriment of out-of-state actors, as is required to successfully challenge a law on dormant Commerce Clause grounds. The court concluded that, based on the evidence put forth by DMA, "the notice and reporting requirements for non-collecting out-of-state retailers are [not] more burdensome than the regulatory requirements in-state retailers already face."

In arriving at its conclusion, the court disagreed with the Department's position that "out-of-state retailers having the option to collect and remit sales tax makes the Colorado Law nondiscriminatory" due to the fact that out-of-state retailers are protected from this option under *Quill*'s physical presence nexus standard. Notwithstanding this acknowledgement, the court further noted that "[w]hether the Colorado Law works a discriminatory effect on interstate commerce turns on the reach of *Quill*" and reiterated its position that *Quill* "applies only to the collection of sales and use taxes" and not the notice and reporting obligations of the Colorado Law. Because the Colorado Law is not a tax, the court disregarded the sales tax nexus protections of *Quill* in determining whether discrimination occurred.

DMA I: The Colorado Law is Not an Undue Burden on Interstate Commerce

The Tenth Circuit also held that the notice and reporting requirements of Colorado Law did not pose an undue burden on interstate commerce. Based on the US Supreme Court's distinction in *DMA II* between tax "assessment, levy or collection" and "information gathering" for purposes of its Tax Injunction Act analysis, the Tenth Circuit determined that *Quill's* physical presence standard is limited in its application to sales and use tax <u>collection</u>. Because the Colorado Law only encompasses informational notices or reports, the Tenth Circuit reasoned that *Quill* is not controlling and the bright-line physical presence standard did not apply to the Colorado Law. Since DMA relied solely on *Quill* for its undue burden claim, the Tenth Circuit did not further entertain the undue burden inquiry.

Fallout From DMA II

In the wake of *DMA II*, Alabama and South Dakota have accepted Justice Kennedy's invitation to challenge *Quill*'s bright-line physical presence nexus standard. Specifically, those states have enacted controversial sales and use tax nexus laws designed to directly conflict with the US Supreme Court's holding in *Quill*.

Alabama

Alabama's challenge to *Quill* is in the form of a regulation that went into effect on January 1, 2016. *See* Ala. Admin. Code 810-6-2.90.03. Pursuant to this regulation, out-of-state sellers without an Alabama physical presence are deemed to "have a substantial economic presence in Alabama for sales and use tax purposes and are required to register for a license with the Department and to collect and remit tax" when (1) such seller's retail sales of tangible personal property to Alabama customers exceed $250,000 per year based on the previous year's sales and (2) the seller conducts one of the activities enumerated in Ala. Code § 40-23-68. The enumerated activities include, among other items, soliciting orders of tangible personal property in Alabama by means of catalogs, commercials on cable television, or a telecommunication or television shopping system. Ala Code § 40-23-68(b)(7)-(10). These activities do not require the retailer to have an in-state physical presence, and, under the terms of the regulation, out-of-state retailers that engage in these activities and exceed the sales threshold are required to collect and remit Alabama sales tax. The enumerated activities also contain a catch-all for maintaining "any other contact with this state that would allow this state to require the seller to collect and remit the tax due under the provisions of the Constitution and laws of the United States."

South Dakota

On March 22, 2016, South Dakota Governor Dennis Daugaard signed S.B. 106 into law, which is effective May 1, 2016. Under S.B. 106, any out-of-state seller selling tangible personal property, products transferred electronically, or services for delivery in South Dakota has nexus with the state for sales tax purposes, if South Dakota gross revenues from the aforementioned sales exceed $100,000 or if the seller made 200 or more separate transactions for delivery in South Dakota.

S.B. 106 also permits the state to bring a declaratory judgment in circuit court against any person the state believes to have met those thresholds, regardless of "whether or not the state initiates an audit or other tax collection procedure." The filing of such declaratory judgment would operate as an injunction, prohibiting the state from enforcing this rule while the case was being determined. Further, any appeal of the declaratory judgment action must be made to the South Dakota Supreme Court with the mandate that "[t]he appeal shall be heard as expeditiously as possible." As noted in the legislature's findings enumerated in S.B. 106, these provisions were designed to expedite the US Supreme Court's ability to reconsider *Quill's* physical presence nexus standard.

Conclusion

The sales and use tax nexus landscape is always being challenged and tested, but the developments listed here could fundamentally change the compliance burden for out-of-state retailers, potentially as a result of a bright-line gross receipts/transactional threshold replacing the physical presence standard for sales tax purposes or as a result of onerous information reporting requirements for use tax purposes. If either outcome is ultimately held to be permissible, it is reasonable to assume that the trend would be for states to adopt similar laws shortly thereafter. *Quill*'s bright-line physical presence nexus standard has endured for 24 years. How much longer will it last?

By: John Paek, Palo Alto and Michael C. Tedesco, New York

OK Computer: California Sales Tax Rules for Software Rebooted

In *Lucent Technologies, Inc. v. State Board of Equalization*, 193 Cal. Rptr. 3d 323 (Cal. Ct. App. October 8, 2015), *cert. denied* January 20, 2016, the California Court of Appeal held that software transferred in conjunction with the concurrent license to copy and use the software was not subject to California sales tax, despite the fact that the software was delivered via magnetic tapes and compact discs, i.e., a tangible medium. As discussed below, the Court of Appeal's decision addresses the arguments presented by the California Board of Equalization ("Board") and appears to provide alternative grounds for exemption: one related to bundled transactions of tangible and intangible property and the other related to intangible property transferred pursuant to a Technology Transfer Agreement ("TTA"). Both grounds favored Lucent Technologies, Inc. ("Lucent").

Lucent manufactured and sold telecommunications switching equipment ("switches") to its telephone company customers. The switches routed telephone calls or data streams to the appropriate destinations on the network and performed other ancillary telecommunication services, such as call waiting, caller ID, three-way calling, voicemail, etc. Lucent also designed the software necessary to operate the switches and licensed it to its customers. The software was copyrighted, and it enabled its customers to use at least one of the patents held by Lucent.

Between January 1,1995 and September 30, 2000, Lucent entered into contracts with its customers to (a) sell the switches; (b) provide instructions on how to install and run the switches; (c) develop and produce a copy of the software necessary to operate the switches; and (d) grant the companies the right to copy the software onto the switch's hard drive and use the software uploaded onto the switches. Lucent provided the software to its customers via magnetic tapes or compact discs, and the companies paid for the licenses to copy and use Lucent's software on their switches.

The ultimate issue was whether the software and the licenses to copy and use the software were subject to California sales tax. The Board contended (1) that the software and licenses were taxable as tangible personal property; (2) that the contracts between Lucent and its customers did not constitute TTAs pursuant to which the software and intangible property would be exempt from sales tax; and (3) that, even if the contracts were TTAs, Lucent did not establish the cost of developing the software, rendering the entire transaction taxable. The California Court of Appeal relied on California precedent to dismiss the Board's arguments and held (1) that the transmission of software on tangible magnetic tapes or compact discs as part of a transaction granting a license to copy and use the software did not transform the software into tangible personal property subject to the sales tax; (2) that the contracts between Lucent and its customers qualified as TTAs; and (3) the value of the blank media is the relevant value of the tangible personal property subject to tax pursuant to the TTAs.

California Default Rule for Bundled Transactions Involving Tangible and Intangible Property

To reach its conclusion that software transferred on tangible media was not tangible personal property, the *Lucent* court set forth and applied the relevant sales tax framework applicable to transactions involving both taxable and non-taxable components: "(1) whether the taxable and not-taxable components are 'inextricably intertwined' rather than 'readily separable'; and if they are inextricably intertwined, (2) whether the not-taxable component is a service or is intangible personal property." If the taxable and non-taxable components are "readily separable," the sales tax is only imposed on the sale of the taxable components.

If the taxable and non-taxable components are "inextricably intertwined," the applicable test depends on whether the non-taxable component is a service or an intangible. If the non-taxable component is a service, "a court is to determine whether the 'true object' test of the transaction is the sale of tangible personal property or instead the performance of a service." On the other hand, if the non-taxable component is intangible property, such as a software license, inextricably intertwined with a taxable component, such as a magnetic tape or disc on which the software is embedded, "the default rule is to determine whether the tangible portion of the transaction is 'essential' or 'physically useful' to the purchaser's subsequent use of the intangible property." If so, then the entire transaction is taxable, and the Court cited film negatives, master audio recordings and artwork to be used to make rubber stamps as examples of tangible property essential to the purchaser's subsequent use of the intangible property. But, if the tangible property is not essential or otherwise physically useful to the buyer's use of the intangible property, then the entire transaction is not subject to tax.

Applying this test, the California Court of Appeal found that the tangible media upon which the software was transmitted was not essential to the buyer's use of the software license. Thus, the Court concluded that the transfer of the software onto magnetic tapes or discs for subsequent installation and use on switches did not convert the software into tangible personal property subject to California sales tax. The Court further noted that the Board's position would lead to an absurd result – holding Lucent liable for $24.7 million in tax simply because it transferred software on magnetic tapes and discs rather than by electronic upload or email.

Intangible Property Transferred Pursuant to a TTA

In addition to finding that the software licenses were not taxable as tangible personal property, the Court also found that the Lucent software licenses would not have been taxable pursuant to the exemption provided for intangible property transferred pursuant to a TTA. A TTA is an agreement under which “a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.” Cal. Rev. & Tax Cd. §§ 6011(c)(10)(D); 6012 (c)(10)(D).

Consistent with the test articulated above for a mixed transaction with “readily separable” taxable and non-taxable components, California’s rules relating to TTAs also provide that only the taxable component of the transaction is taxed, and the intangible, non-taxable component is not taxed. Specifically, “a taxpayer who enters into a contract that qualifies as a technology transfer agreement is required to sort the tangible personal property from the intangible, and to pay sales tax on the tangible personal property that is transferred but not on ‘the amount charged for [the] intangible personal property transferred.’” *See Lucent. See also* Cal. Rev. & Tax Cd. §§ 6011(c)(10)(A), 6012(c)(10)(A). The value of the tangible property is determined by using one of the following methods, listed “in declining order of preference. . . : (1) the price stated in the agreement itself; (2) the price at which ‘the tangible personal property or like tangible personal property has been previously sold or leased, or offered for sale or lease, to third parties at a separate price’; or (3) 200 percent ‘of the cost of materials and labor used to produce the tangible personal property’. . . .” *See Lucent. See also* Cal. Rev. & Tax Cd. §§ 6011(c)(10)(A)-(C), 6012(c)(10)(A)-(C).

The Court found that Lucent’s contracts with its customers qualified as TTAs because they met all of the requirements of the statutory definition. Lucent held and licensed copyrighted and patented software property, meeting the requirement that a person hold a patent or copyright. Lucent provided the telephone companies a license to reproduce its copyrighted software onto the switches, meeting the remaining TTA requirements that such a holder of a patent or copyright interest assign or license “to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.” Cal. Rev. & Tax Cd. §§ 6011(c)(10)(D); 6012 (c)(10)(D). As a result, the Court found that the Lucent contracts were TTAs, noting that its prior decision in *Nortel Networks, Inc. v. State Board of Equalization*, 119 Cal. Rptr. 3d 905 (Cal. Ct. App. 2011), a case dealing with an almost identical transaction that was found to qualify as a TTA, was “exactly on point and came to the same conclusion.”

In determining that the Lucent contracts were TTAs, the Court made two key findings that should be of interest for taxpayers attempting to qualify for TTA treatment. First, the Court noted that “[t]he transfer of a single copyright interest is sufficient” to qualify as a TTA, meaning that a single copy of the software from a disc onto a switch was adequate for TTA purposes. Second, the Court rejected the Board’s suggested requirement that the TTA statutes are inapplicable unless the taxpayer made a *prima facie* showing that “absent the right-to-use licenses in the agreement, [its] customers would have infringed on [the taxpayer’s] patent or copyright interests when using the acquired software.” The Court dismissed the Board’s proposed requirement, not only because it does not appear in the TTA statutes, but also because it would effectively nullify the TTA statutes by turning “every taxpayer refund action involving the technology transfer statutes into a full-blown copyright and/or patent trial. . . . to refute every possible copyright and patent defense. . . .”

After finding that the Lucent contracts were TTAs, the Court dismissed the Board's claim that the tangible property component transferred pursuant to the TTAs was not properly established in the TTAs. The Court found that "the price of *blank* media is the price of the tangible personal property, and is what is to be taxed under the technology transfer agreement statutes."

Lucent-based Refunds and Prospective Effects

The Board appealed the Court of Appeal's decision, and the California Supreme Court denied the Board's petition for review on January 20, 2016. The Board is in the process of considering the effects of *Lucent*, and the Board's Legal Department issued a memorandum on March 18, 2016, outlining its recommendations and indicating that the Board's staff is prepared to begin processing refund claims for which they can "verify the existence of a software TTA between an exclusive holder-retailer and a purchaser-licensee pursuant to the subsequent use of the licenses regarding that software."

The Board's Legal Department recommended that the regulations relating to TTAs and Computers, Programs, and Data Processing (Cal. Code Regs. tit. 18, §§ 1502, 1507) be amended "to clarify the requirements to establish that an agreement for the transfer of software on tangible storage media is a software TTA, in accordance with the primary holding in *Lucent*, and clarify the measure of tax when software is transferred under a software TTA." The Board's Legal Department also recommended that the Board issue a notice to clarify that:

> "(1) the typical off-the-shelf retail sale of canned, mass marketed software still does not constitute a software TTA because the typical retailer can only sell tangible storage media and does not hold any intangible copyright or patent interest in the software to transfer with the storage media; and (2) *Lucent* is only dispositive with respect to software transmitted on tangible storage media that is wholly collateral to the subsequent use of the licenses regarding that software and is not dispositive with respect to embedded non-custom software or pre-loaded non-custom software, which were not at issue in *Lucent*."

While the Board has not yet issued any firm guidance on *Lucent*, its Legal Department's recommendations may provide taxpayers with a preview of some aspects of the Board's prospective position, which could be in tension with *Lucent*'s bundled transaction rule applicable to a transaction containing tangible and intangible property. If the Board were to adopt a "wholly collateral" standard relating to tangible property in lieu of the "not essential" or "physically useful" standard articulated by the Court, audit disagreements could be reasonably anticipated to ensue.

Software sellers should consider whether they are eligible for refund claims filed pursuant to *Lucent*. Even though they may not be eligible for refunds based on their historical business model, such companies should evaluate whether they can adjust their business model on a prospective basis to qualify for sales tax exemption pursuant to *Lucent*, keeping in mind that such a position could be subject to challenge depending on the Board's eventual response.

By John Paek, Palo Alto and David Andrew Hemmings, Chicago

Canadian Tax Update

The newly elected Liberal government released its inaugural budget ("Budget 2016") on March 22, 2016. The following is a summary of certain significant tax proposals included in Budget 2016 that may be of interest to multinationals with Canadian operations.

International Tax Measures

Extension of the Back-To-Back Rules

The Canadian Income Tax Act (the "ITA") currently includes "back-to-back loan" rules to prevent taxpayers from interposing a third party between a Canadian borrower and a foreign lender in order to reduce the amount of Canadian withholding tax that would otherwise apply. Budget 2016 proposes four enhancements to the back-to-back rules to further prevent the erosion of the Canadian tax base.

1. Back-To-Back Rules for Rents, Royalties and Similar Payments

The ITA generally imposes a 25% withholding tax on rents, royalties or similar payments made by a resident of Canada to a non-resident. This rate may be reduced or eliminated by an income tax treaty. Accordingly, taxpayers may be motivated to interpose an intermediary entity resident in a tax treaty country having a low (or lower) withholding rate between a Canadian payor and a foreign payee that is resident in a less favorable jurisdiction for royalty withholding tax purposes. Budget 2016 proposes to extend the back-to-back loan rules to royalty payments. Where the proposed rules apply, the Canadian payor will be deemed to have made a royalty payment directly to the ultimate non-resident payee.

2. Character Substitution Rules

Budget 2016 has proposed that certain character substitution rules be considered to be "back-to-back" arrangements. These rules may apply where (i) interest is paid by a Canadian payor to an intermediary and the intermediary is obliged to pay a royalty to a non-resident person, or vice-versa; or (ii) interest or royalties are paid by a Canadian payor to an intermediary and a non-resident person holds shares of the intermediary that include certain obligations in respect of the payment of dividends. Where a back-to-back arrangement exists, an additional payment having the same character as the payment by the Canadian payor to the intermediary will be deemed to have been made directly by the Canadian payor to the non-resident person.

3. Back-To-Back Shareholder Loan Arrangements

Where a debt is owing by a shareholder of a Canadian corporation to the corporation and has been outstanding for more than a year, the amount of the debt may be included in the shareholder's income. Where the shareholder is a non-resident, this income is deemed to be a dividend subject to Canadian withholding tax. Budget 2016 proposes to amend the shareholder loan rules to deem a shareholder of a corporation to be indebted directly to the corporation where there is a back-to-back shareholder loan arrangement.

4. Multiple Intermediary Arrangements

Budget 2016 proposes rules to clarify that the existing and proposed back-to-back rules will apply to back-to-back arrangements involving multiple intermediaries.

Cross-Border Surplus Stripping

The paid-up capital ("PUC") of a class of shares of a Canadian corporation can generally be distributed to non-resident shareholders as a tax-free return of capital. Distributions in excess of PUC are subject to Canadian withholding tax of 25% (subject to reduction under an applicable tax treaty). The ITA contains an "anti-surplus stripping" rule to prevent a non-resident shareholder from extracting amounts in excess of PUC on a tax free basis or from artificially increasing PUC. Budget 2016 includes proposed amendments to this anti-surplus stripping rule to prevent perceived abuses.

Base Erosion and Profit Shifting

The Organisation for Economic Co-operation and Development (the "OECD") released a package of recommendations to address base erosion and profit shifting ("BEPS") on October 5, 2015. Canada, together with the other G20 members, endorsed the recommendations at the November 2015 G20 Leaders' Summit. The Canadian Government is moving forward with a number of initiatives to address BEPS and is also acting on certain recommendations from the OECD BEPS project.

1. Transfer Pricing Documentation – Country-By-Country Reporting

The OECD BEPS recommendations include a minimum standard for country-by-country reporting. The country-by-country report is a form that a large MNE will be required to file with the tax administration of the country in which the MNE's ultimate parent resides. The report will provide a high-level overview of the MNE's global operations. The country that receives a country-by-country report will automatically exchange the report with other jurisdictions in which the MNE operates, provided that: the other jurisdiction has country-by-country reporting requirements; both jurisdictions have a legal framework in place for the automatic exchange of information; and they have entered into a competent authority agreement relating to country-by-country reporting.

Budget 2016 proposes to implement country-by-country reporting for MNE's having total annual consolidated revenue of €750 million or more. A country-by-country report will have to be filed with the Canada Revenue Agency (the "CRA") by the ultimate parent entity that is resident in Canada within one year of the end of the fiscal year to which the report relates. The Government expects the first exchanges of country-by-country reports to occur by June 2018 with jurisdictions with which the CRA has formalized an exchange agreement. Country-by-country reporting will be required for taxation years beginning after 2015.

2. Treaty Abuse

The BEPS minimum standard requires countries to include an express statement in their tax treaties that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. In addition, under the minimum standard, countries must adopt one of two approaches to anti-abuse rules: (i) a general anti-abuse rule which looks at whether the principal purpose of an arrangement or transaction was to obtain treaty benefits; or (ii) a more specific anti-abuse rule requiring the satisfaction of a series of tests in order to qualify for treaty benefits. Budget 2016 confirms the Government's commitment to address treaty abuse in accordance with the BEPS project's minimum standard requirements.

3. Spontaneous Exchange of Tax Rulings

The BEPS project developed a minimum standard for the spontaneous exchange of tax rulings in the following categories: (i) rulings related to preferential regimes; (ii) cross-border unilateral advance pricing arrangements; (iii) rulings giving a downward adjustment to profits; (iv) permanent establishment rulings; (v) conduit rulings; and (vi) any other type of ruling agreed to in the future. Budget 2016 confirms the Government's intention to implement the BEPS minimum standard in this regard. The CRA will begin exchanging tax rulings in 2016 with other jurisdictions that have also committed to the minimum standard for the spontaneous exchange of certain tax rulings.

Business Income Tax Measures

Debt Parking to Avoid Foreign Exchange Gain

When a debt is denominated in a foreign currency, a debtor would normally realize a foreign exchange gain or loss for Canadian income tax purposes when the debt is settled or extinguished. However, a debtor may avoid realizing a foreign exchange gain by entering into a "debt-parking" transaction whereby the debtor arranges for a non-arm's length person to acquire its debt from the initial creditor for an amount equal to the principle amount of the debt. In this manner, the debt could remain owing indefinitely. Budget 2016 includes proposals to prevent debt-parking to avoid the realization of accrued foreign exchange gains on foreign denominated debt.

Eligible Capital Property

"Eligible capital property" ("ECP") generally includes intangible property such as goodwill and patents, licenses, franchise rights and copyrights having an indefinite term. Under the current regime, 75% of an ECP expenditure is added to a taxpayers "cumulative eligible capital" ("CEC") pool and is deductible at an annual rate of 7% on a declining balance basis. Budget 2016 proposes to replace this ECP/CEC regime with a new class of depreciable property. One hundred percent of an ECP expenditure will be added to the new depreciable property class. Annual depreciation will be allowed at a rate of 5% on a declining balance basis. Extensive transitional rules are provided.

Sales and Excise Tax Measures

Budget 2016 proposes that supplies of call center technical/customer support services to unregistered non-resident persons will qualify for zero-rating if it can reasonably be expected at the time the supply is made that the services are to be rendered primarily to individuals who are outside Canada.

Budget 2016 also addressed a rule that subjected many businesses that ordinarily would not be viewed as financial institutions to the complex rules that are applicable to financial institutions, such as the obligation to file an annual information return and the obligation to self-assess tax in respect of intangible personal property and services acquired outside Canada. Under the existing legislation, businesses that earned over $1 million in interest, fees or other charges in connection with the making of an advance, lending of money or granting of credit were deemed to be "*de minimis*" financial institutions. Budget 2016 proposes to address this problem by providing that interest from demand deposits and term and guaranteed investments certificates with a maturity less than one year will not be included in determining whether a person exceeded the $1 million threshold. The new rules will generally apply to taxation years that begin on or after March 22, 2016.

By Lesley Kim, Alex Pankratz and Randall Schwartz, Toronto

Out with Audits, In With Campaigns: LB&I Reorganizes—Again

In February 2016, the IRS's latest restructuring of its LB&I Division officially rolled out. LB&I reorganized once again into nine geographic and subject-matter practice areas, all reporting to one deputy commissioner. As part of the restructuring, LB&I is moving away from continuous audits and instead to centralized campaigns to address compliance issues. Many taxpayers wonder what the latest LB&I reorganization may mean to them. Jenny A. Austin, Daniel A. Rosen, and Susan E. Ryba consider the effects of the LB&I reorganization and campaigns on taxpayers in their article, *Out With Audits, In With Campaigns: LB&I Reorganizes—Again*. This article originally appeared in the March 3, 2016, issue of Bloomberg BNA's Daily Tax Report, and is also available under publications at www.bakermckenzie.com.

Final Foreign Asset Reporting Regulations for US Entities and Trusts

The IRS issued final regulations requiring certain US entities and trusts to report the ownership of their foreign financial assets. The new reporting requirements apply to certain closely held corporations and partnerships with predominantly passive income. Although domestic trusts are subject to these reporting requirements, trusts that meet certain conditions are exempt. Trustees of US trusts holding foreign financial assets should determine if they qualify for an exemption to avoid penalties for failure to report.

The IRS issued the final regulations under Code Section 6038D. Section 6038D requires US individuals (e.g., US citizens, US tax residents and residents of certain territories and possessions) to report information about their "specified foreign financial assets" on Form 8938 if the value of those assets exceed certain thresholds. The final regulations extend Form 8938 reporting to US domestic entities and trusts that are formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets in the same manner as if the entity were an individual. The final regulations apply for tax years beginning after December 31, 2015.

For a full discussion on these final regulations, please see previously released Tax Client Alert *Final Foreign Asset Reporting Regulations for US Entities and Trusts* distributed on March 4, 2016 and available under publications at www.bakermckenzie.com.

UK Changes to Royalty Taxation Will Impact Multinational Groups

Last month the UK government sprung an unwelcome surprise on businesses with an announcement of major reforms to the tax treatment of royalties. All these changes are very significant, and will bring new complications for groups with a UK presence that is making payment for IP. They consist of (a) a treaty override for withholding tax on royalties paid to connected persons as part of a tax-motivated scheme; (b) widening the range of royalty payments that are subject to withholding tax; and (c) introducing withholding tax on royalty payments connected with a UK permanent establishment (PE) or deemed PE under the UK diverted profits tax regime (DPT). Groups affected will need to consider possible solutions.

For a full discussion of these reforms, please visit previously released Global Tax Client Alert, *UK Royalty Tax Changes Set to Impact IP*, distributed in April 2016 and also available under publications on www.bakermckenzie.com.

The Impact of Transfer Pricing on Compensation Deductions

Most multinationals put significant time and attention into transfer pricing, but few consider the impact of transfer pricing on their compensation deductions. Two fundamental issues exist. First, in a multinational company with mobile employees, it can be unclear which entity is entitled to the compensation deduction in the first instance. And, second, once it is determined which entity has the compensation deduction, a question arises whether the transfer pricing shifts the underlying compensation deduction or simply results in a separate charge to the related company. In an article published in the March/April 2016 issue of *Corporate Taxation*, *When Employees Cross Borders – Does the Compensation Deduction Cross With Them?*, Anne G. Batter and Barbara J. Mantegani provide an overview of the rules governing which entity in a multinational group bears the compensation deduction in the first instance, and the various reasons why this is important (such as Code Section 162(m) and 457A). The article also proposes, in the absence of guidance directly on point, a framework for considering whether transfer pricing impacts the compensation deduction.

For the complete article, please see *When Employees Cross Borders - Does the Compensation Deduction Cross With Them?*, also available under publications on www.bakermckenzie.com.

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Comment Letter Submitted to Treasury and the IRS on the FIRPTA Exemption for Qualified Foreign Pension Funds

The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), which Congress enacted on December 18, 2015, exempts certain "qualified foreign pension funds" from tax on their US real estate investments under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). Last month, a comment letter was submitted to Treasury and the IRS requesting confirmation that eligible foreign pension funds will not lose the benefit of the FIRPTA exemption merely because they hold their real estate investments indirectly through various types of investment entities. The comment letter is available through *Tax Notes Today* http://www.taxnotes.com/tax-notes-today/real-estate-taxation/firm-seeks-certainty-tax-withholding-exemption-under-path-act/2016/03/23/18295101 and also available by clicking here.

Baker & McKenzie Co-sponsors Global Tax Controversy and Transfer Pricing Conferences

TEI Audits and Appeals Seminar - Managing International Tax Controversies in Challenging Jurisdictions – Santa Clara

As part of the TEI Audits and Appeals Seminar May 17-19, 2016 in Santa Clara, California, Baker & McKenzie is pleased to once again sponsor a full day of international tax controversy instruction on Thursday, May 19. *Managing International Tax Controversies in Challenging Jurisdictions* will offer participants the opportunity to gain insight into technical, strategic and practical tax controversy issues and foreign audits. We invite you to join Baker & McKenzie tax practitioners and representatives from tax authorities, including keynote speaker **Doctor Tizhong Liao**, *Director General, International Taxation Department, State Administration of Taxation, People's Republic of China*, as they discuss issues that may arise for multinationals operating in challenging markets such as China, Mexico, Brazil and India. For more information and instructions on how to register, please visit www.bakermckenzie.com/eventtaxauditappealsseminarmay16/.

Additionally, Baker & McKenzie practitioners will be available for one-on-one meetings before and after the seminar. If you are interested in scheduling a one-on-one meeting, please contact Lindsay Morrin at lindsay.morrin@bakermckenzie.com.

Baker & McKenzie/Bloomberg Global Transfer Pricing Conference Series: Washington, DC - Toronto - Hong Kong

As multinational corporations continue to navigate the changing transfer pricing landscape in a post-BEPS world, Baker & McKenzie and Bloomberg BNA remain at the forefront of providing the most essential thought leadership with the ***Baker & McKenzie/Bloomberg BNA Global Transfer Pricing Conference Series*****.**

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With annual events held in Paris, Washington, DC (June 8-9), Toronto (August 29-30) and Hong Kong (September 19-20), this conference series is the go-to destination for multinational organizations seeking insight on the issues unique to the markets in which they operate.

After a successful event in Paris last month, Baker & McKenzie is excited to join Bloomberg BNA in hosting the second conference of the series at the National Press Club in Washington, DC on June 8-9, 2016. This two-day conference will feature sessions on country-by-country reporting, intangibles, attribution of profits to permanent establishments, dispute resolution and pending transfer pricing court cases, customs, and a variety of other topics. Attendees will have the opportunity to hear the latest insight on the challenges arising from the implementation of the BEPS Project from Baker & McKenzie tax practitioners, corporate tax executives, and leading tax authorities and policy makers, including officials from the US, UK and Mexico. Confirmed government speakers include:

- ***Christopher Bello****, Chief, Branch 6, Office of the Associate Chief Counsel (International), IRS*
- ***Hareesh Dhawale,*** *Director, Advance Pricing and Mutual Agreement Program, IRS*
- ***Brian Jenn,*** *Attorney-Advisor, Office of International Tax Counsel, US Treasury*
- ***Carlos Perez Gomez Serrano****, Director of Transfer Pricing Examinations, Mexican Tax Administration Service (SAT)*
- ***Sharon Porter,*** *Director, Treaty and Transfer Pricing Operations Practice Area, IRS*
- ***Robert Stack****, Deputy Assistant Secretary for International Tax Affairs, US Treasury*
- ***Michael Williams****, Director Business and International Tax, HM Treasury*

Agenda and registration details are available at www.bna.com/2016-global-transfer-pricing-washington-dc. Register today using Baker & McKenzie corporate guest code **BAKDC16** to receive a discounted rate of $1,095 (regularly $1,395).

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For further information regarding the North American Tax Practice Group, any of the items or Upcoming Events appearing in this Newsletter, or to receive *Tax News and Developments* directly, please contact Marie E. Caylor at +1 312 861 8029 or marie.caylor@bakermckenzie.com.

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