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Canadian and U.S. Tax Law: A Review of 2014 and a Look Forward to 2015

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Each year at this time, we offer a look back at some of the more significant business and international tax developments in Canada and the United States over the past year and a look forward to possible Canadian and U.S. tax developments in the coming year.

I. CANADIAN TAX REVIEW AND OUTLOOK

A. A Review of Canadian Tax Developments in 2014

Legislative Developments

Compared with recent years, relatively few new business and international income tax measures were proposed in 2014.

New income tax measures frequently become effective from the date of announcement. But over the past decade or so, proposed measures often were not enacted on a timely basis, resulting in a substantial legislative backlog. Taxpayers were, nonetheless, expected to file their tax returns on the basis that the proposed amendments were law. Fortunately, in 2013, a 1,000 plus-page technical bill enacted most of these outstanding legislative amendments. In 2014, Bill C-43 (which received royal assent on December 17, 2014) enacted the balance of the significant measures that were outstanding, and also enacted new measures proposed in 2014.

2014 Budget

The tax measures in the 2014 Canadian federal budget, which was delivered on February 11, 2014, were thin compared with those of the last few years. The principal business and international changes, which were enacted as part of Bill C-43, included the following:

Passive income rules for foreign subsidiaries. Under the *Income Tax Act* (Canada) (ITA), income that is considered "foreign accrual property income" (FAPI) of a controlled foreign subsidiary of a Canadian taxpayer is taxed in Canada on a current basis whether or not such income is distributed to the Canadian taxpayer. The 2014 budget included two amendments to the FAPI rules:

- An existing exception from FAPI for a foreign subsidiary's income from a regulated financial business was substantially narrowed by, among other things, making the exception available only where the Canadian taxpayer in respect of the foreign subsidiary is a regulated Canadian financial institution or a subsidiary or parent of such a regulated financial institution.
- An anti-avoidance rule that deems income of a foreign subsidiary from insuring Canadian risks to be FAPI was expanded to apply to derivative "insurance swap" arrangements between foreign subsidiaries of Canadian taxpayers and third parties if at least 10% of the tracked risks are Canadian risks.

Thin capitalization and withholding tax changes. The Canadian thin capitalization rules deny the deduction of interest on debt owing by Canadian businesses to non-residents who hold 25% or more of the equity in the Canadian businesses or who are connected to persons holding 25% or more of the equity to the extent that the relevant debt exceeds 1.5 times the relevant equity of the Canadian business. These rules were expanded in the 2012 and 2013 budgets, and were further expanded in the 2014 budget as described below.

In addition, interest paid by a Canadian resident to a non-resident person with whom the payer does not deal at arm's length is subject to withholding tax under the ITA. Interest paid to a non-resident person with whom the Canadian payer deals at arm's length is exempt from Canadian withholding tax except where the interest is "participating debt interest".

Both the Canadian thin capitalization rules and the withholding tax rules were amended to target intra-group cross-border financing arrangements involving "back-to-back loan" arrangements utilizing a third-party intermediary to circumvent the application of these rules. The version of the amendments proposed in the 2014 budget was very broad and created a great deal of uncertainty about the Canadian treatment of standard borrowing arrangements for multinationals. These initial proposals were scaled back materially, and the version of the proposals enacted by Bill C-43 largely alleviated the concerns that arose in these standard borrowing arrangements. However, the amendments can in certain circumstances have adverse consequences if the intermediary involved in the back-to-back loan transactions is a related party. In effect, they contain an unexpressed anti-treaty-shopping rule for intra-group financing structures.

Non-resident trust rules and immigration trusts. The Canadian non-resident trust rules tax a non-resident trust as a resident of Canada where Canadian residents contribute property to the trust. The 2014 budget eliminated an exception that has existed from these rules for "immigration trusts" – trusts whose contributors are individuals who have been resident in Canada for not more than 60 months.

Treaty Shopping

The Canadian government's attempts to challenge perceived treaty-shopping abuses in court have been markedly unsuccessful. In 2013, the Department of Finance released a consultation paper on treaty shopping and the 2014 budget proposed for consultation a specific statutory anti-treaty-shopping rule. Broadly, the proposal included a "main purpose" rule and a "conduit presumption" that would trigger the application of the rule and a "safe harbour" presumption that is subject to the conduit presumption.

Questions were raised about how the proposed anti-treaty-shopping rule would interact with Canada's tax treaty obligations. There also were questions about front-running on the OECD's project on base erosion and profit shifting (BEPS). Just weeks before the OECD was set to release extensive working papers from its own process, the Department of Finance announced that the treaty-shopping proposals would be suspended pending further work by the OECD on BEPS. It is unclear whether this was a simple show of procedural respect to the OECD or whether Canada has decided to rely on the BEPS process, at least provisionally. In either case, if BEPS gets off track, Finance may well resurrect this initiative in short order.

Amendments to the Foreign Affiliate Dumping Rules

The "foreign affiliate dumping rules" were introduced in 2012 and apply when a non-resident corporation controls a Canadian corporation (CRIC) that makes an investment in a foreign affiliate. Where the rules apply, the investment by the CRIC in the foreign affiliate is treated as a dividend by the CRIC to its controlling non-resident shareholder for withholding tax purposes, except to the extent of any available cross-border capital. The rules were introduced in response to perceived abuse of the Canadian tax system by multinational groups "stuffing" debt into Canada and undertaking transactions to utilize surplus in Canada for group purposes outside Canada. Their scope and complexity is daunting.

On August 16, 2013, the Canadian government released for consultation proposals to amend various aspects of the foreign affiliate dumping rules. The proposed amendments were generally relieving in nature. On August 29, 2014, a revised version of these 2013 proposed amendments were released and ultimately enacted as part of Bill C-43. With the exception of the inclusion of a new anti-avoidance rule in the cross-border capital offset provisions and a provision requiring the filing of prescribed information in certain circumstances, the revisions to the 2013 amendments were mostly improvements in response to submissions received in the 2013 consultation period.

While the proposed amendments are for the most part welcome, the rules are still much broader than their stated objectives would suggest necessary, contain numerous traps and will continue to deter many legitimate foreign investments in Canadian companies.

The foreign affiliate dumping rules can have significant consequences for foreign-controlled Canadian corporations with foreign subsidiaries and for acquisitions of Canadian corporations with significant foreign subsidiaries, even in apparently benign situations. This is particularly the case in the resource sector where CRICs are often established to raise capital on the Toronto Stock Exchange for foreign businesses and have no Canadian tax base to erode. The rules must be considered in almost all capital transactions with a cross-border component when a CRIC is involved.

Other Legislative Amendments Included in Bill C-43

Bill C-43 also enacted proposals from 2012 intended to alleviate the tax cost to Canadian-based banks of using excess liquidity of their foreign subsidiaries in their Canadian operations.

In addition, it enacted amendments initially put forward in 2013 addressing highly technical, but often important, issues including the following: (i) rules clarifying certain aspects of the treatment of foreign corporations without share capital (such as U.S. limited liability companies, or LLCs) and Australian trusts; (ii) amendments addressing the application of the foreign affiliate rules to structures containing partnerships; (iii) an amendment broadening an intra-group financing safe harbour in clause 95(2)(a)(ii)(D) of the ITA; (iv) a relieving amendment to an anti-base-erosion rule relating to the provision of services in paragraph 95(2)(b) of the ITA; and (v) amendments denying a tax-deferred merger of foreign affiliates where the merger is part of a transaction or series of transactions that includes the sale of shares of the merged corporation to an arm's-length person.

International Tax Treaty Developments

Agreement with the U.S. Foreign Account Tax Compliance Act

On February 5, 2014, the U.S. Treasury Department and the Canadian government signed an intergovernmental agreement (IGA) dealing with the application of the U.S. *Foreign Account Tax Compliance Act* (FATCA) rules to Canadian taxpayers. The agreement is a "Model I" agreement, which provides for direct exchange of the information required to be provided under FATCA between the United States and Canada, with each government collecting from its local financial institutions the relevant information on account holders who are taxpayers of the other country. It had been reported that Canada was seeking to limit its disclosure obligations to account holders who are U.S. residents, but unfortunately the IGA does impose reporting on Canada with respect to U.S. citizens resident in Canada. The main beneficiaries of the IGA are Canadian financial institutions (FFIs) under FATCA that will be spared the need to enter into individual FATCA FFI Agreements with the Internal Revenue Service (IRS). Canadian FFIs still need to register through the IRS web portal for FATCA to obtain a global intermediary identification number (GIIN) to avoid the withholding rules on U.S. source payments. The Canadian statutory provisions giving effect to the agreement were enacted in 2014.

Tax Information Exchange Agreements

Five more tax information exchange agreements (TIEAs) entered in force in 2014 (with Brunei, Uruguay, Bahrain, the British Virgin Islands and Liechtenstein). Canada now has a total of 22 TIEAs in force and is in TIEA negotiations with eight countries to conclude agreements. The Canadian government has been actively seeking TIEAs with tax haven countries in order to improve domestic tax enforcement.

To encourage tax havens to enter into TIEAs with Canada, dividends received by a Canadian corporation out of active business income of a foreign affiliate resident in a jurisdiction with which Canada has a TIEA have been made exempt from Canadian tax. As a stick to go along with this carrot, active business income of a controlled foreign affiliate is taxed in Canada on an accrual basis (in the same manner as foreign passive income or FAPI) where the controlled foreign affiliate is resident in a jurisdiction that fails to enter into a TIEA with Canada within 60 months of Canada seeking to enter into negotiations for a TIEA with that country and that has not signed the OECD *Convention on Mutual Administrative Assistance in Tax Matters*.

With 22 TIEAs now in force (including with the Cayman Islands, the British Virgin Islands and Bermuda), the range of attractive jurisdictions within which to establish foreign affiliates of Canadian corporations has grown significantly.

Amendments to Canada-United Kingdom Tax Treaty

On July 21, 2014, Canada and the United Kingdom signed the fourth protocol to the Canada-United Kingdom tax treaty, amending a number of its articles and introducing an interpretive protocol intended to provide a common understanding and interpretation of certain provisions of the treaty. The protocol provides for the following, among other things:

- an exemption from withholding tax on interest (other than participating interest) paid on loans between persons who are dealing at arm's length so that payments by a U.K. resident to a Canadian resident will no longer be subject to withholding tax provided that the parties are dealing at arm's length; and
- an exemption from withholding tax on dividends paid by portfolio companies to organizations that administer recognized pension plans provided that certain conditions are met. Since the United Kingdom does not generally levy withholding tax on dividends, this exemption will be more relevant to U.K. pension funds.

Notably, the protocol does not amend the capital gains article of the Canada-United Kingdom tax treaty. The article provides that, for the purposes of determining whether gains from the disposition of shares of a corporation or an interest in a partnership or trust by a resident country taxpayer are taxable in the source country on the basis that the shares or interests derive the greater part of their value from immovable property in that country, immovable property does not include real property (other than rental property) in which the business of the corporation, partnership or trust is carried on. While the Department of Finance has indicated that it would seek to align the definition of immovable property in Canada's tax treaties to the definition of taxable Canadian property in the ITA, the protocol does not provide for this. Given that Canada has a number of significant tax treaties with similar provisions, this may have broader implications.

Judicial Developments

The principal noteworthy Canadian tax case in 2014 dealing with international matters is the Federal Court of Appeal's decision in *Lehigh v. The Queen*, which considered the application of the anti-avoidance rule in paragraph 95(6)(b) of the ITA.

Paragraph 95(6)(b) provides that where a person acquires or disposes of shares of a corporation and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer any amount payable under the ITA, for the purposes of the foreign affiliate rules the acquisition or disposition is deemed not to have taken place. Given the nature of paragraph 95(6)(b) and the broad interpretation put on it by CRA, this case had significance far beyond its specific facts.

The taxpayers had contributed funds to an LLC that loaned the funds to a U.S. operating affiliate (U.S. Opco). U.S. Opco paid interest to the LLC and it was intended that under the Canadian foreign affiliate rules the interest would be deemed to be active business income and exempt surplus to the LLC. The LLC used the interest income to pay dividends to the taxpayers. The taxpayers reported on the basis that they received dividends from a foreign affiliate (the LLC) that were exempt from Canadian tax. For U.S. tax purposes, the LLC was a partnership and the interest income of the LLC was allocated to the taxpayers and subject to a 10% U.S. withholding tax. Therefore, from a U.S. tax perspective, the transactions resulted in a reduction of U.S. Opco's operating income by virtue of the interest deductions at the cost of a 10% U.S. withholding tax on the interest received by the LLC.

The Canada Revenue Agency reassessed the taxpayers under paragraph 95(6)(b), arguing that the LLC interests were acquired by the taxpayers principally to avoid tax under the ITA and, therefore, the LLC interests were deemed to not be acquired by the taxpayers for the purposes of the foreign affiliate rules. On this basis, the LLC would not qualify as a foreign affiliate of the taxpayers and the dividends would not constitute exempt dividends.

The Tax Court held that paragraph 95(6)(b) did not apply to the taxpayers on the basis that the transactions were intended to reduce U.S. tax and were not undertaken to avoid Canadian tax. Although the Tax Court came to a favourable conclusion for the taxpayer in *Lehigh*, the Tax Court's comments on the breadth of paragraph 95(6)(b) were quite controversial. In particular, the Tax Court stated: "A textual, contextual and purposive analysis leads to the conclusion that the provision can apply to any acquisition or disposition of shares that is principally tax-motivated." Since dividends on shares of foreign affiliates generally receive beneficial tax treatment under the ITA, the acquisition of any share that results in a non-resident corporation becoming a foreign affiliate of a taxpayer could in many cases be argued to be tax-motivated and potentially subject to paragraph 95(6)(b). The Tax Court also considered the purpose of the series of transactions that included the acquisition of shares to be relevant to the application of paragraph 95(6)(b), despite the absence of any statutory language to that effect.

The Canada Revenue Agency appealed the decision in *Lehigh* to the Federal Court of Appeal. Although the Court upheld the Tax Court's decision, the Federal Court interpreted paragraph 95(6)(b) much more narrowly. The Federal Court of Appeal stated that paragraph 95(6)(b) applies only where *the principal purpose* of the acquisition or disposition of the shares *is the manipulation of the share ownership of a non-resident corporation to meet or fail the relevant tests* for qualifying as a foreign affiliate or controlled foreign affiliate in order to access the benefit of the foreign affiliate regime or avoid the adverse consequences of the FAPI regime. However, the Canada Revenue Agency stated at the 2014 annual conference that, in spite of the Federal Court of Appeal's decision in Lehigh, it believed that paragraph 95(6)(b) could apply in other contexts.

B. Outlook for Canadian Tax Developments in 2015

The Department of Finance's general policy of developing tax legislation in confidence means any predictions about future tax developments can only be guesses. The entirely unforeseen scope of additional tax developments over the last few years is proof of this.

The previous few budgets have included a number of revenue-raising measures and with the continued focus on balancing the budget in the face of decreasing oil prices, it is possible that the Canadian government will propose further measures to tighten the Canadian tax system, even in an election year. And many provincial governments face serious financial difficulties, whether as a result of oil revenue declines or because of unrelated structural deficits.

Currently, taxpayers are taxed in respect of FAPI of a foreign subsidiary only where the foreign subsidiary is a "controlled foreign affiliate" of the taxpayer. A 2008 government-sponsored advisory panel recommended a number of amendments to Canada's international tax system. The government has made a number of changes based on the panel's recommendations (including the 2012 and 2013 amendments to the thin capitalization rules and the foreign affiliate dumping rules). One of the tightening measures considered by the panel was whether the FAPI regime should be extended to apply to certain non-controlled foreign affiliates. It is unclear whether the government is considering possible amendments in this regard.

With further work on the treaty abuse aspect of BEPS expected to occur by September 2015, we may see a decision in 2015 on how the Canadian government intends to proceed with curtailing treaty shopping. In addition, it is possible that amendments to the ITA may be proposed as a result of the work on the other action items underlying BEPS.

In 2013, the Tax Court of Canada released its long-awaited transfer pricing decision in *McKesson Canada v. The Queen*. The Tax Court upheld the CRA's transfer pricing adjustment and the taxpayer in *McKesson* appealed the decision to the Federal Court of Appeal. The Federal Court of Appeal may hear this case in 2015.

The Tax Court of Canada was expected to begin hearing the *GlaxoSmithKline* transfer pricing case again on January 12, 2015. However, it is understood that the case was settled just before the start of trial. On October 18, 2012, the Supreme Court of Canada, in rendering its decision in *GlaxoSmithKline Inc. v. The Queen*, referred the case back to the Tax Court for reconsideration.

II. U.S. TAX REVIEW AND OUTLOOK

A. A Review of U.S. Tax Developments in 2014

In the previous version of this update, at the beginning of 2014, (i) we noted the prevalence of BEPS (the anti-"base erosion and profit shifting" initiative of the OECD and G-20) in the press and calls for developments sweeping the international tax scene, but causing only a ripple in the United States; (ii) we predicted that FATCA would consume substantial resources of both the government and investors; and (iii) we guessed that major efforts at substantial tax reform in the United States would likely get "bogged down".

We appear to have been correct on all fronts, though perhaps not ambitious enough to anticipate (a) the degree and consistency of efforts by U.S. companies to seek opportunities to "invert" and the publication of Notices by the IRS that have placed impediments in the pathway; (b) the furor in Europe against "state aid", including leakage of details of tax rulings of a certain Benelux country, and pronouncements from the OECD on BEPS that mainly met its ambitious self-imposed deadlines; and (c) the general warming on the political scene after hard-fought mid-term congressional elections that have installed a Republican majority in the Senate (and retained it in the House of Representatives) early in 2015 and changes in the membership of the major tax writing committees of both bodies (due to turnover of the majority in the Senate and retirements in the House, including that of Representative Dave Camp, Chair of the House Ways and Means Committee); these changes may for the first time in years set the stage for significant new tax legislation in the United States. Before peering further into our crystal ball, however, we provide a brief review of the major U.S. tax developments in 2014.

Tax Treaties Frozen in the U.S. Senate, But Movement May Lie Ahead Despite Senator Rand Paul's Privacy Concerns

Under the U.S. Constitution, tax treaties are negotiated by the President but are subject to the "advice and consent" of the Senate. The United States has treaties in force with 66 countries. Since 2010, however, no treaty or protocol has been approved by the Senate. In 2011, the Senate's Foreign Relations Committee reported on five treaties or protocols, including those with Luxembourg, Switzerland, Hungary and Chile and an agreement on mutual assistance. That committee held hearings in June 2014; the committee also held a hearing on a new protocol with Spain and on the new treaty with Poland. The committee has not yet considered a pending protocol with Japan or the treaty with Vietnam. A new protocol with Norway and a new treaty with Romania are expected to be signed shortly. The holdup appears to be Senator Rand Paul, who joined the Senate in 2011 and who has consistently objected to tax treaties and their exchange-of-information provisions. Treasury Department representatives have defended inclusion of exchange-of-information provisions as being a standard for five decades. Moreover, the United States has tax-information exchange agreements with nations with which it has no income tax treaty, and FATCA-related agreements with over 50 nations. Privacy concerns are legitimate, particularly in a world in which hackers seem to be able to obtain private data at will and journalists who obtain private tax information stolen from governmental archives feel free to publish that information without repercussion. But the overall interests of the government of the United States seem strangely hostage to this particular ratification process. We predict that treaties will once again find ratification in the U.S. Senate beginning in 2015.

Tax Legislation: Rational Hesitancy in 2014

Little tax legislation was passed in 2014. Ironically, the results of an improved economy and shifts in Congress after the mid-term elections in November 2014 increased the likelihood of significant tax legislation being enacted at the end of 2014 and in 2015.

Tax extenders. Indeed, while no major tax legislation was enacted in 2014, an "Extenders Bill" was enacted on December 19, 2014. That bill provided short-term extensions (generally only to the end of 2014) for certain popular tax expenditures, including the research credit, bonus depreciation, relief for individuals losing their homes and small business tax relief. On the international front, relief was provided in the form of short-term extensions of the look-through on intercompany payments by controlled foreign corporations (CFCs), the banking and insurance exceptions for CFCs and the exception from taxation of non-residents under the Foreign Investment in Real Property Tax Act with respect to certain interests in publicly traded U.S. funds.

BEPS. As noted above, the United States did not act to implement rules that would apply BEPS principles broadly, but few nations have acted to implement BEPS and most have suspended action until the remaining reports are released. The United States has been a leader in adopting unilateral rules to prevent base erosion and profit shifting through adoption of anti-earnings-stripping rules, adoption and enforcement of transfer pricing rules, development of rules preventing avoidance of U.S. withholding taxes through hybrid mismatches involving entities and certain securities, systematic adoption of a "limitation on benefits" provision in its bilateral income tax conventions, tax transparency rules in FATCA, its mechanism encouraging intergovernmental agreements and information exchange, maintenance of worldwide taxation of U.S. residents and citizens, and limiting the timing of or access to foreign tax credits in certain circumstances. Areas that BEPS may affect, and that the United States has not systematically addressed, include the specific taxation of companies involved in e-commerce, including a new regime for intangibles or highly mobile income, country-by-country disclosure of transfer pricing information, or development of a mechanism for adoption of multilateral tax treaties. We expect the United States to move slowly on these remaining fronts, though movement is possible on revising the taxation of income from intangibles in the context of any major changes to the regime for taxing international income of U.S. multinationals.

Inversions. Legislation was proposed in 2014 to reduce the threshold for treating the acquiring foreign corporation in an inversion transaction as a U.S. parent company, but much of the political pressure for action seems to have been blown off by the IRS's publication of its Notice 2014-52 on September 22, 2014. That Notice is described further below.

Tax reform legislation. Ambitious proposals were made by the Obama Administration and the Chair of the House Ways and Means Committee, Rep. Dave Camp (Michigan), to reform the Internal Revenue Code. Both proposals would have reduced corporate rates, but the Administration's approach would have eliminated deferral of certain offshore earnings, including those of companies operating in the digital economy, while the Camp Proposal would have moved significantly in the direction of a territorial tax system, with a 95% dividends received deduction from active income of a CFC), a 15% minimum tax on intellectual property income earned abroad, and a tax of only 5.25% on previously deferred earnings (which could have been paid over eight years). The Administration also proposed strengthening the anti-inversion rules.

IRS guidance. More action occurred at the level of the U.S. Treasury Department, as pressure mounted to "do something about inversions" in the press. Indeed, the IRS issued a number of important notices, which, cumulatively, have had the intended effect of reducing the number of inversion transactions (and cases that qualify for an exception to treating the acquiring foreign corporation as a domestic corporation).

Anti-inversion notices. As indicated above, in Notice 2014-52, the IRS announced prospective regulations (prospective from September 22, 2014, the date of publication of the Notice). As we wrote within days of the release, Notice 2014-52 has indeed changed the playing field, by reducing the number of foreign acquiring corporations that can be used to accommodate an inversion acquisition of a U.S. target corporation. Those transactions require shareholders of the foreign corporation to hold over 20% of the combined company in order to avoid having the foreign acquiring corporation treated as a U.S. corporation for U.S. tax purposes. Notice 2014-52 changes how such 20% is counted and limits the U.S. tax benefits that can be achieved by inverting. Following publication of the Notice, at least one previously announced corporate combination transaction was scuttled. Temporary Regulations dealing with certain aspects of the 20% test were also published earlier in 2014. An earlier IRS pronouncement, Notice 2014-32, targeted a technique used in one inversion transaction to avoid gain recognition by U.S. shareholders under section 367(a).

FATCA Implementation

New form W8-BEN-E. The IRS finally published its revised withholding tax forms for implementing the complex new rules under FATCA, which generally go into effect in 2015. New Form W8-BEN-E (the "E" is for entities) extends for many pages and provides many challenges for foreign entities that have to determine their FATCA status – and application of any IGA under FATCA – in order to avoid 30% withholding on U.S. source payments and to claim any treaty relief.

Deadlines for registering as an FFI. Foreign financial institutions that are not resident in a jurisdiction that has entered into (or is treated as having entered into) a Model I intergovernmental agreement (IGA) had to file by July 1, 2014 to avoid FATCA withholding tax. FFIs resident in a Model I IGA jurisdiction had until December 31, 2014 to register.

Further IGAs. Under the IGA program, and model agreements, a Model 1 IGA provides for reporting of FATCA information to a foreign government (which will then share the information with the IRS) rather than (under a generally less popular Model 2 IGA) directly to the IRS. According to the IRS, by July 1, 2014, 101 jurisdictions had signed or agreed to sign an IGA. Since that time, more have indicated willingness and intent to sign an IGA. Thus, in Announcement 2014-38, the IRS identified additional jurisdictions on the list of those treated as having an IGA in effect in substance and extended the deadline beyond December 31, 2014 for having those IGAs completed. The Announcement also provided procedures to follow before those IGAs are published, and procedures to follow if the nation with which an in-substance IGA has been announced does not later sign.

Boilerplate relief for tax advisors. One technical change made in 2014 may actually have more of a practical impact on more people than any development during the year –, namely removal of the requirement of tax-penalty disclaimer language on virtually all external legal correspondence. That change can be found in proposed regulations for practice before the IRS under the heading "Circular 230" – but the proposed regulations provide that reliance can be placed on the new rules even before they are finalized.

Relief from failure to file "gain recognition notices" on outbound transfers. The IRS finalized regulations that provide some relief from failure to file a gain recognition notice or completion of its continuing filing requirements.

New procedures for non-compliant filers. The IRS announced changes to the 2012 Offshore Voluntary Disclosure Program, increasing the penalties and imposing stricter filing timelines for taxpayers accepted into the program. At the same time, the IRS expanded the Streamlined Procedures for non-wilful violators by, among other changes, adding a new 5% penalty regime for U.S. resident taxpayers making corrective offshore filings. The IRS is continuing to pursue information on taxpayers who hide money offshore.

New procedures for owners of RRSPs. The IRS has eliminated the need for an owner of an RRSP to file IRS Form 8891 and to affirmatively elect to defer the income earned in the RRSP under Article XVIII(7) of the United States-Canada treaty, so long as the taxpayer timely files a federal income tax return that omits the income of the RRSP.

B. Outlook for U.S. Tax Developments in 2015

The future is as cloudy as ever, but, as noted above, we are more optimistic about the possibility of treaty ratification and substantive legislation beyond extenders.

Congressional outlook. We are witnessing substantial turnover in the tax-writing committees in Congress and with that some greater likelihood of enactment of tax reform legislation. Indeed, the new Chairs of the House Ways and Means Committee and the Senate Finance Committee are reportedly in favour of a territorial tax system. With the retirement of Representative Camp (from Michigan) came the appointment of Representative Paul Ryan (from Wisconsin), who has some fiscal credentials, and is a possible Republican presidential candidate. With a shift in power of the Senate to the Republican Party, the Chair of the Senate Finance Committee will be Senator Orrin Hatch (from Utah). Senator Hatch recently released a report by the Republican committee staff outlining what they see as the key policy issues in tax reform. Wide-sweeping tax reform is unlikely in 2015, because any reduction in corporate tax rates is likely to come with a demand from the Obama Administration for offsetting revenues, and that condition could stay reform since Republicans do not have sufficient votes in Congress to override a presidential veto.

One risk is that with both parties looking for more revenue, presently favoured industries may need to strengthen their defences against proposed changes in law. Despite Administration support for increasing assistance to infrastructure, along with increasing incentives for foreign pension plan investment in real property and infrastructure, that industry already benefits from a variety of deferral and rate-reduction provisions, including like-kind exchanges, REITs and favourable regulatory and governmental interpretations. Furthermore, foreign investment in the form of debt typically attracts no U.S. taxation while interest payments are generally deductible (subject to earnings-stripping rules). The Administration has long pursued strengthening the earnings stripping rules for inverted companies and may push for strengthening of those rules generally. The IRS may continue to attack debt structures under common law standards for distinguishing debt from equity – though its track record in court has not been good – it has been delegated broad regulatory authority to adopt more clear-cut guidance for taxpayers in this area.

Regulatory outlook. With guidance under FATCA largely complete, the U.S. Treasury Department and the IRS could turn their attention to a pile of regulations that are long overdue. Interestingly, few of those projects deal with items identified above (to be dealt with by legislation or court controversy). One exception in the international arena is the issuance of regulations to determine whether sale by a non-resident of a partnership interest in an active U.S. business gives rise to gain that can be taxed by the United States (several cases are pending in the U.S. Tax Court on this issue). While some guidance is expected on inversions, the regulatory projects do not appear to cover new ground.

In its most recent business plan, the IRS is targeting the following projects, among others, that may be of interest to our readers: finalizing proposed regulations under the limited income tax exemption available to governmental entities; treaty issues with hybrid instruments; rules relating to interests in passive foreign investment companies; treatment of insolvent company restructurings; technical issues in spinoffs and tax-free corporate reorganizations; certain issues involving REITs; issues arising under incentive and deferred compensation arrangements; dealing with contingent instalment sales rules; guidance on the source of income arising in the digital economy; and guidance on the U.S. tax treatment of investments in (and by) partnerships held by CFCs.

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