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U.S. Tax Laws: A Review of 2015 and a Look Ahead to 2016

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

I. REVIEW OF U.S. TAX DEVELOPMENTS IN 2015

As we anticipated in our outlook for last year, no comprehensive tax reform was enacted in 2015. However, revisions to the tax laws that appeared late in the year resulted in additional benefits for foreign investors in real estate and infrastructure assets, instead of the reduction in benefits that we predicted at this time last year.

A. Tax Legislation: Ending with a Bang

At the end of a relatively quiet year for tax legislation, Congress released a tax extenders package that included some major tax changes, especially for foreign persons who invest in U.S. real estate.

PATH Act

A wide-ranging package of tax reforms known as the "PATH Act" was enacted in late December. Its provisions are expected to encourage foreign investment in the United States, especially with respect to real estate and infrastructure assets. Chief among the changes is a complete exemption for qualified foreign pension funds and their wholly owned subsidiaries from FIRPTA, a U.S. tax regime that subjects foreign owners of U.S. real estate to federal income taxes and imposes a withholding tax on the disposition of U.S. real estate by foreign persons. Since foreign pension funds deploy huge amounts of capital, eliminating FIRPTA taxation could open up new avenues of financing for infrastructure and other real-estate-related projects in the United States.

The PATH Act also made the R&D tax credit permanent and extended other energy-related tax credits. The continued availability of these tax credits should also encourage investment in U.S. infrastructure and other assets.

In addition, the PATH Act includes changes that benefit foreign investors in U.S. REITs, including the following:

- The foreign ownership threshold for a publicly traded REIT to be exempt from FIRPTA has been increased from 5% to 10%.

- Certain publicly traded entities are no longer taxed on FIRPTA gains but will instead be subject to withholding tax at a slightly reduced rate. This change would not apply to the extent that entities are held more than 10% by a single shareholder.

- The built-in gains recognition period for a corporation that elects to be a REIT has been permanently reduced to five years.

- Debt instruments of publicly offered REITs are now qualifying assets under the REIT asset tests, although no more than 25% of a REIT's total assets may consist of such debt instruments.

A handful of REIT provisions that are not favourable to REITs were also included in the PATH Act. Most important, under the PATH Act, a corporation that has been involved in a tax-free spinoff under section 355 is prohibited from making a REIT election for 10 years. This provision is meant to discourage an increasingly popular tax reduction strategy where a large corporate taxpayer spins its real estate assets out into a new holding company, which then elects to be a REIT. Over the past few years, this strategy has been used by taxpayers engaged in real-estate-intensive industries such as casinos, document storage and server farms. This provision is effective for REIT spinoffs taking place after December 7, 2015, other than spinoffs for which private letter ruling requests had already been filed by that date.

The provisions of the PATH Act that apply to REITs are generally effective as of December 31, 2015, although, as noted above, some provisions have special effective dates.

The impact of these provisions on the real estate industry remains to be seen. The increased attractiveness of U.S. real estate to foreign pension funds, however, has the potential to create a major new source of financing for persons who operate and develop real estate and related activities in the United States.

Finally, the PATH Act extended a number of other international tax provisions, such as the look-through rule for inter-company payments by controlled foreign corporations and the active financing income exemption from subpart F.

Partnership Audit Procedures

Also late in the year, Congress expanded the power of the Internal Revenue Service (IRS) to collect underpayments of tax relating to partnership audits. Under newly revised section 6226, a partnership will be liable for tax, interest and penalties with respect to partner-level underpayments resulting from partnership-level adjustments, unless the partnership qualifies for and makes an annual election to opt out. The new partnership audit rules will apply for taxable years beginning in 2018 and later.

B. Administrative Developments

The IRS issued several significant items of guidance that reflect its concern with potential tax avoidance transactions, particularly in the international context.

Inversion Notice

This year witnessed the largest public inversion transaction so far. In addition, public debate intensified, and corporate inversions became a talking point for the current crop of presidential candidates. In response to such increasing public pressure, the IRS issued additional restrictions on inversion transactions in Notice 2015-79. Its provisions include a limitation on third-country parents and foreign acquirers not subject to worldwide taxation in their country of origin, and an expansion of assets and transactions that will be ignored in determining whether there has been an inversion.

Lending Funds

Early in 2015, the IRS issued a chief counsel memorandum, CCA 201501013, in which it took the position that a foreign fund that conducted lending and underwriting activities within the United States through a fund manager with discretionary authority was itself engaged in a taxable trade or business within the United States.

The IRS took the position that the activities of the fund manager were attributed to the foreign fund because the fund manager was acting as the foreign fund's agent, regardless of whether the fund manager was a dependent or independent from the foreign fund. The IRS examined the nature of the lending and underwriting activities attributed to the foreign fund and argued that those activities constituted an active trade or business in the United States and were not merely investing. Moreover, the lending and underwriting activities were too extensive to qualify as "trading in stocks and securities", and accordingly the foreign fund could not take advantage of safe harbours in the law that are commonly relied on to prevent trading from being considered a U.S. trade or business. Finally, the IRS concluded that, even if the fund's activities were trading, the fund did not qualify under the plain language of the safe harbours because the fund's activities were conducted through an agent with discretionary authority.

Although CCA 201501013 does not provide new law, its analysis gives insight into the IRS's thinking on an issue for which definitive guidance is lacking.

Spinoff No-Rule Areas

As described above, the PATH Act restricts REIT elections by spun-off corporations in order to discourage corporate taxpayers from reducing their overall tax burden by spinning off their real estate assets into REITs. There was also much discussion this year about a proposed spinoff by Yahoo! of its holdings in Alibaba, which was seen by many as inconsistent with the requirement under section 355 that a controlled corporation have an active business.

After refusing to rule on the Yahoo! transaction, the IRS set its sights on this kind of spinoff with Revenue Procedure 2015-43. The IRS announced in this Revenue Procedure that it will no longer rule, absent "unique and compelling reasons", on spinoffs in which the fair market value of the active trade or business (of either the distributing or controlled corporation) is less than 5% of the fair market value of the gross assets of such corporation (other than spinoffs occurring solely within a corporate group).

In Revenue Procedure 2015-43, the IRS also announced that it no longer intended to rule on spinoffs involving REITs and RICs absent unique and compelling reasons. In the case of spinoffs involving REITs, however, the IRS’s no-rule position was rendered irrelevant by the provision of the PATH Act that prohibits a corporation involved in a spinoff from making a REIT election for 10 years after the spinoff.

In addition, the IRS will no longer rule on proposed spinoffs (other than spinoffs occurring solely within a corporate group), regardless of whether there are "unique and compelling reasons", if

(i) the fair market value of the investment assets of the distributing or controlled corporation is two-thirds or more of the total fair market value of its gross assets; (ii) the fair market value of the active trade or business of such corporation is less than 10% of the fair market value of its investment assets; and (iii) the ratio of the fair market value of the investment assets to the other assets of the distributing or controlled corporation is three or more times the corresponding ratio for the other corporation.

Although Revenue Procedure 2015-43 is a clear signal as to the IRS's position on such transactions, it is not a direct attack on them. Presumably, corporations that contemplate a spinoff covered by these rules may rely on an opinion of tax counsel or other comfort that their transaction should be respected.

Partnerships with Related Foreign Partners

In Notice 2015-34, the IRS announced that it intends to issue regulations that would require a partner to recognize any built-in gain on the contribution of appreciated property to a partnership, if the partnership has one or more foreign partners that are related to the contributing partner. These regulations would discourage certain arrangements that the IRS believes delay or avoid the recognition of gain by allocating income to a partner that is not subject to tax but is part of the same affiliated group as the contributing partner.

Final Regulations Under Section 871(m)

The IRS released final regulations that apply to "dividend equivalents", or payments on certain derivative contracts that are contingent on or determined with reference to U.S.-source dividends. Under these rules, payments of dividend equivalents that would otherwise be foreign-source are treated as U.S.-source and are accordingly subject to U.S. federal withholding tax. The final regulations were generally consistent with the proposed version, although notable differences included an increase in the level of "delta" required for the regulations to apply, from 0.7 to 0.8, and a provision that withholding with respect to a dividend equivalent is not required any earlier than when a payment is actually made. The final regulation will generally apply to transactions entered into after January 1, 2017.

Regulations Proposed on Transfers of Goodwill to Foreign Corporations

Under section 367(a) of the Internal Revenue Code, certain transfers of intangible property (not including goodwill and going concern value) to a foreign corporation are taxable even if they are to be used in an active trade or business of the foreign corporation. Section 367(d) imputes a royalty payment to the transferor of certain intangible property (not including foreign goodwill and going concern value). Proposed regulations under section 367 provide that transfers of foreign goodwill and going concern value would no longer be excepted from the gain recognition and deemed royalty provisions of 367(a) and (d).

C. Updates on Tax Treaties and BEPS

We noted in last year's update that the United States had not ratified a tax treaty since 2010, and several treaties had been held up in the ratification process through the efforts of Senator Rand Paul. The freeze continued through 2015, delaying the ratification of treaties with Switzerland, Japan, Luxembourg, Chile, Hungary, Spain and Poland. These treaties were, however, unanimously approved by the Senate Foreign Relations Committee, along with an international convention on mutual assistance on tax matters. The full Senate must still ratify the treaties before they become effective.

The Treasury Department released new provisions for the U.S. model tax treaty, which reflect policy concerns similar to those that underlie the base erosion and profit shifting (BEPS) initiative currently being spearheaded by the OECD and the G20 group of nations. The provisions include a denial of treaty benefits for certain "triangular" arrangements; denial of reduction in the rate of withholding on dividends, interest, royalties and other amounts paid by entities that have expatriated in an inversion transaction; denial of treaty benefits with respect to certain "special tax regimes"; inclusion of a broader "derivative benefits" rule; and a provision that allows a country to partially terminate a treaty in response to certain changes in law adopted by the other country.

The final version of these provisions should be released sometime in 2016, although it remains to be seen whether they will have any near-term impact since many tax treaties are currently being held up in Congress.

In October, the OECD released its final recommendations on BEPS. The next step in the BEPS project is for member countries to implement the recommendations. In the United States, changes to both current law and the existing tax treaty network would be required to achieve this. Some developments, such as the changes to the model tax treaty described above, are already under way. In 2016, the United States will continue to participate in BEPS, although it is not expected to lead the process and it may take a selective approach with regard to which BEPS recommendations are implemented.

D. Judicial Developments

In 2015, several pending tax cases were of interest:

Ingersoll-Rand

In early 2015, the IRS settled a treaty-shopping case with Ingersoll-Rand Company for $86 million in withholding taxes. The dispute related to a 2002 inversion transaction in which Ingersoll-Rand changed its tax residency to Bermuda and subsequently migrated to Ireland, in 2009. Ingersoll-Rand had restructured certain inter-company notes so that interest payments were due no longer to the Bermuda company but rather to subsidiaries in Barbados, Hungary and Luxembourg, which resulted in reduced rates of withholding tax under the applicable tax treaties. The taxpayer paid the full amount of the IRS's assessed taxes in the settlement, although penalties seem to have been dropped.

Magnesite

The IRS takes the position that, if a partnership is engaged in a U.S. trade or business and generates effectively connected income (ECI), then any gain recognized by a foreign person when that person sells an interest in the partnership is itself ECI. The IRS's position was documented in Revenue Ruling 91-32 (published in 1991). Since then, this ruling has generated substantial controversy. In *Grecian Magnesite, Mining, Industrial and Shipping Co. S.A. v Commissioner*, currently pending before the Tax Court, a taxpayer is arguing that the statutory language of section 741 of the Internal Revenue Code trumps and deflects the IRS on this issue. The Tax Court will likely issue an opinion in this case sometime in 2016.

II. OUTLOOK FOR U.S. TAX DEVELOPMENTS IN 2016

The main question for 2016 is whether Congress will tackle comprehensive tax reform now or whether it will wait until a new presidential administration arrives in January 2017. The passage of significant taxpayer-favourable provisions as part of the PATH Act may have paved the way for additional tax reform in 2016.

In addition to the provisions of Notice 2015-79 regarding inversions noted above, the IRS hinted that it will soon announce proposed regulations on earnings stripping transactions. Although no timeline for this guidance was announced, pressures on the Treasury Department to stop the corresponding loss of tax revenue should make this a priority in 2016.

The Treasury Department is expected to release the final revised version of its model tax treaty, which should take into account comments received in 2015 and should include the remaining provisions that were not previously issued in proposed form. What impact the model treaty will have on future bilateral negotiations is not clear, nor are its implications for the large number of signed treaties and protocols still awaiting ratification by the full Senate.

As noted above, a decision over the controversy on dispositions of ECI partnerships is expected from the Tax Court in 2016. Decisions may also appear in several U.S. tax cases regarding transfer pricing issues, such as the *Altera* case, which challenges the IRS's rules on transfer pricing of stock-based compensation, as well as the *Medtronic*, *Eaton* and *Cambridge* cases, which also hinge on transfer pricing issues. Finally, the U.S. Supreme Court has been asked to hear challenges to the IRS's application of the economic substance doctrine in the foreign tax credit context in *Salem Financial, Inc. v United States* and *Bank of N.Y. Mellon Corp. v Commissioner.* It remains to be seen whether the Court will grant *certiorari* in these cases.

If you have any questions regarding the foregoing, please contact Ian Crosbie (416.367.6958) or Raj Juneja (416.863.5508) in our Toronto office; Nathan Boidman (514.841.6409), Brian Bloom (514.841.6505) or Michael Kandev (514.841.6556) in our Montréal office; or Peter Glicklich (212.588.5561), Abraham Leitner (212.588.5508) or Heath Martin (212.588.5563) in our New York office.

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