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Canadian and 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 Canada and the United States over the past year and a look ahead to possible Canadian and U.S. tax developments in the coming year.

I. CANADIAN TAX REVIEW AND OUTLOOK

A. Review of Canadian Tax Developments in 2015

1. Canadian Tax Rates

From 2008 to 2012, corporate taxpayers in Canada operated in an environment of declining tax rates, with the general federal corporate tax rate falling to 15% in 2012. In connection with these federal tax rate reductions, the Canadian Minister of Finance had encouraged all Canadian provinces to decrease their provincial corporate tax rates to 10% by 2013 so that Canada could have a national corporate tax rate of 25%. Alberta already had a provincial corporate tax rate of 10%, two provinces (British Columbia and New Brunswick) responded by reducing their corporate tax rate to 10%, and Ontario announced gradual decreases of its corporate tax rate that would result in its corporate tax rate being 10% by July 1, 2013.

However, this trend of decreasing corporate tax rates ended in 2012 when Ontario froze its provincial corporate tax rate at 11.5% (for a combined rate of 26.5%). In addition, British Columbia and New Brunswick increased their provincial corporate tax rates in 2013 to 11% (for a combined rate of 26%) and 12% (for a combined rate of 27%), respectively.

Moreover, Alberta increased its provincial corporate tax rate to 11% in 2015 (for a combined rate of 26%) and to 12% on January 1, 2016 (for a combined rate of 27%).

Personal income tax rates for Canada's top earners have also been on the rise in Canada. Both Ontario and Québec increased their highest marginal tax rates in 2012 and 2013, and Alberta increased its personal tax rates on October 1, 2015. In addition, the newly elected Canadian Liberal government increased the highest marginal personal tax rate (the rate for income in excess of $200,000) by 4% effective January 1, 2016 (and implemented a modest decrease in tax rates for income in the $45,282 to $90,563 bracket). The combined federal and provincial highest marginal personal tax rates across the provinces range from 48% to 58.75%. The highest combined marginal tax rate in Ontario is 53.53% and in Québec, 53.31%.

2. Legislative Developments

Compared with recent years, relatively few new business and international income tax measures were proposed in 2015. The principal measures were announced as part of the 2015

federal budget, delivered on April 21, 2015. Revised versions of the proposed rules were included in draft legislation on July 31, 2015.

The statutory references in this section are to the *Income Tax Act* (Canada) (Canadian Tax Act).

Inter-Corporate Dividend Deduction and the Subsection 55(2) Anti-Avoidance Rule

Dividends paid by one Canadian corporation to another are generally received tax-free under the inter-corporate dividends received deduction in subsection 112(1), subject to a refundable tax that can apply to certain dividends received by private corporations. The availability of the dividends received deduction has long been subject to an anti-avoidance rule in subsection 55(2), which is intended to prevent the payment of tax-free dividends for the purpose of reducing or avoiding capital gains on the disposition of the shares of the dividend payer. The rule is not intended to apply to dividends that are derived from "safe income" (generally after-tax retained earnings). Canadian corporations are not restricted under corporate law to paying dividends out of earnings, and Canada has never had tax rules like the U.S. "earnings and profits" test to classify distributions as dividends or not. Instead, the rule in subsection 55(2) has been the principal tool for policing the use of tax-free dividends for capital gains stripping.

In the 2015 federal budget, the Canadian government proposed to substantially broaden this anti-avoidance rule, applying it to circumstances beyond capital gains stripping transactions. In particular, the rule will now also apply where one of the purposes of the dividend is to effect a significant reduction in the fair market value of any share or to effect a significant increase in the cost of property of the dividend payer. In addition, the exception from subsection 55(2) for dividends within a related group will now only apply to a deemed dividend that arises on the redemption or repurchase of a share.

The amendments to subsection 55(2) were proposed in response to unfavourable court decisions and a perception at the Department of Finance that the rules had deficiencies. The amendments are very broad and make it difficult to use dividends to move funds within a Canadian corporate group, at least not without first having computed the payer corporation's safe income, a computation that is itself fraught with difficulties. The Department of Finance received numerous submissions critical of the proposed amendments, and it remains to be seen whether it will relax them so as not to impede everyday movements of cash within a corporate group.

The deduction under subsection 112(1) and the anti-avoidance rule in subsection 55(2) are cornerstones of the Canadian corporate tax regime, and the 2015 budget was the first time in over two decades that the Canadian government proposed fundamental policy changes to them.

The proposed amendments to subsection 55(2) have not yet been enacted but are intended to apply retroactively from April 21, 2015, once enacted.

Equity Derivatives and the Inter-Corporate Dividend Deduction

A Canadian corporation that receives dividends on shares of another Canadian corporation that are held to hedge a short position under a swap or other derivative is generally permitted to deduct the amount of those dividends in computing its taxable income pursuant to the inter-corporate dividends received deduction under subsection 112(1), unless it may reasonably be considered that the main reason for entering into the derivative was to enable the taxpayer to

receive the dividend, and under the derivative someone other than the corporate taxpayer bears the risk of loss or enjoys the opportunity for gain or profit with respect to the share in any material respect.

In the 2015 federal budget, the Canadian government proposed the "synthetic equity arrangement" rules, which would extend this denial of the deduction under subsection 112(1) to situations where the derivative has the effect of providing to the counterparty all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share, without the existing purpose test. An exception to this new rule is provided if the taxpayer can establish that no "tax-indifferent investor" has all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share by virtue of the derivative or another connected equity derivative. A tax-indifferent investor is a person who is exempt from tax under the Canadian Tax Act or a non-resident person who does not receive amounts under the synthetic equity arrangement through a permanent establishment in Canada and certain trusts and partnerships that include such tax-exempt and non-resident persons.

These rules have not yet been enacted but are intended to apply retroactively from November 1, 2015, for arrangements entered into, extended or renewed after April 21, 2015, and from May 1, 2017, for arrangements entered into on or before April 21, 2015.

Captive Insurance

Generally, a Canadian taxpayer is subject to tax in Canada on an accrual basis in respect of foreign accrual property income (FAPI) earned by the taxpayer's controlled foreign affiliates.

In the 2015 federal budget, the Canadian government proposed new measures that will extend the FAPI rules to ceding commissions earned by foreign affiliates from the ceding of Canadian risks to third parties. A ceding commission is a fee paid by a reinsurance company to its counterparty (the cedant) to compensate the cedant for its administrative costs in respect of the ceded risks and/or for a percentage of the profits earned from the risks. For these purposes, a foreign affiliate's income (and FAPI) from ceding Canadian risks includes the difference between the fair market value of any consideration received for the ceding of Canadian risks and the foreign affiliate's cost in respect of such risks. This rule is intended to apply to transactions in which a foreign affiliate sells Canadian risks and receives foreign risks as part of the same arrangement. These proposals expanded on rules included in the 2014 federal budget that targeted "insurance swap" transactions.

These rules have not yet been enacted but are intended to apply for taxation years that begin after April 20, 2015.

3. Judicial Developments

The Application of GAAR to Loss Utilization

In *Birchcliff v The Queen*, the Tax Court of Canada considered whether the general anti-avoidance rule (GAAR) applied to deny the utilization of non-capital losses by the taxpayer. The losses in question were incurred by a predecessor corporation, Veracel Inc. (Veracel), which was amalgamated with Birchcliff Energy Ltd. (Birchcliff) to form the taxpayer.

Veracel had ceased business in 2002. It had accumulated non-capital losses before ceasing business and began seeking proposals with respect to its tax attributes in 2004. Birchcliff was a

newly created public company that entered into agreements to purchase oil and gas properties and required financing to purchase the properties. Birchcliff and Veracel were introduced, and a plan was devised to amalgamate the two companies in 2005 to allow the utilization of the losses of Veracel after the amalgamation. The plan involved Veracel issuing subscription receipts to third party investors that provided for the issuance of common shares of Veracel immediately before the amalgamation. After the amalgamation of Veracel and Birchcliff to form the taxpayer, the taxpayer used the cash received on the issuance of the subscription receipts to purchase the oil and gas properties that Birchcliff had previously agreed to purchase. On the amalgamation, the original Veracel shareholders received a modest preferred share interest in the taxpayer, which was redeemed for cash.

Since the new shareholders of Veracel acquired a majority interest in the taxpayer on the amalgamation of Veracel and Birchcliff, the loss streaming rules that can otherwise be engaged on an amalgamation did not apply to the use by the taxpayer of the Veracel losses.

The Tax Court held that the transactions were abusive and that GAAR applied to deny the taxpayer's use of the Veracel losses on the following grounds: "Parliament did not want amalgamations and reverse takeovers being used as techniques to avoid an acquisition of control in situations where the original Lossco shareholders do not collectively receive shares representing a Majority Voting Interest in the combined enterprise."

The taxpayer has appealed the Tax Court's decision to the Federal Court of Appeal. While it is easy to appreciate the CRA's policy concern on these facts, it is much less clear that GAAR should apply to these transactions. Accordingly, the appeal may shed interesting light on the interpretation of GAAR.

What Constitutes Debt?

In *Barejo Holdings v The Queen*, the Tax Court of Canada considered whether two instruments entitled "Notes" issued by foreign affiliates of two Canadian banks constituted debt for the purposes of the Canadian Tax Act. The Notes did not bear interest and provided for a payment on maturity that reflected the performance of an actively managed portfolio of assets held by an affiliate of the issuers. The Notes had a maturity date of November 30, 2016, 15 years after their issue, and were specified to rank *pari passu* with the issuers' other unsecured obligations.

The Tax Court stated that the Notes evidence what can be called a hybrid investment as they had some of the characteristics of debt (such as, in the Court's view, a stipulated interest rate, which was nil) but also had some characteristics that were quite different from a typical debt investment. In considering such an instrument, the Tax Court concluded it was necessary to determine whether the instruments in substance reflected a debt relationship or another relationship, such as equity, whose features they also exhibit.

The Tax Court ultimately concluded that the Notes did constitute debt for the purposes of the Canadian Tax Act. The Tax Court's decision has been appealed to the Federal Court of Appeal.

Characterization of Swaps as Income or Capital

In *George Weston v The Queen*, the Tax Court of Canada considered whether gains realized by a taxpayer on the settlement of cross-currency swaps were on income or capital account. The taxpayer had entered into the swaps in order to preserve its consolidated balance sheet equity and protect against Canadian dollar (CAD) and U.S. dollar (USD) foreign exchange fluctuations

that would create volatility in the taxpayer's consolidated balance sheet equity. The CAD/USD exchange fluctuations were relevant to the taxpayer, as it had various existing and newly acquired businesses in the United States that were carried on through indirectly held subsidiaries. As such, the CAD/USD fluctuations affected the taxpayer's consolidated equity, which in turn affected its debt to equity ratio. When the risk of currency fluctuations had been reduced (its debt to equity ratio had returned to acceptable levels), the taxpayer terminated the swaps.

The CRA argued that gains on the swaps could be on capital account only if it could be shown that the swaps were linked to an underlying transaction that was the purchase or sale of a capital asset, the repayment of a debt denominated in a foreign currency or the investment of idle capital funds. Since the swaps in question were not linked to any transaction or debt obligation of the taxpayer denominated in a foreign currency that it entered into on its own account, the CRA was of the view that the gains realized by the taxpayer on the swaps were on income account.

The Tax Court held in favour of the taxpayer, finding sufficient evidence to conclude the taxpayer's intent and purpose for entering into the swaps was to hedge the risk of currency fluctuations on its investment in the U.S. operations in order to counteract their impact on the taxpayer's capital structure and the value of its direct investments in its subsidiaries.

This decision was not appealed, and the CRA has stated that it accepts the decision in *George Weston*. The decision contradicts previous policy statements of CRA that took a very narrow view of linkage requirements. As such, this is a welcome shift to a more reasonable environment for the treatment of hedging transactions.

B. Outlook for Canadian Tax Developments in 2016

1. Possible Legislative Developments

The Department of Finance's general policy of developing tax legislation in confidence means any predictions about future tax developments are usually guesses. One exception may be the tax treatment of stock options. The newly elected Liberal government indicated in its election platform that it intended to increase taxes on employee stock option benefits by restricting Canadian resident employees from claiming the stock option deduction (i.e., the capital gains equivalent taxation) in respect of option benefits in excess of $100,000 annually. Unless there is a change of heart, proposals to implement the employee stock option changes may be included in the 2016 federal budget. There has been lobbying by industry sectors for exceptions from the rules and some indication that the Department of Finance is having difficulty settling on the proper rule, so there may be further developments on this issue. Based on comments by the Minister of Finance, it is expected that any changes with respect to the taxation of stock options would take effect only from the date they are announced and would not affect options issued before that date.

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.

It is uncertain how and to what extent the new Canadian government will implement the recommendations of the Organisation for Economic Co-operation and Deveopment (OECD) on the highly publicized base erosion and profit shifting (BEPS) measures. On October 5, 2015, the

OECD presented the final reports respecting BEPS. Along with recommendations as to "best practices" or "common approaches", the package includes new "minimum standards" that are backed by a commitment of all OECD and G20 countries to consistent implementation. Such endorsement indicates Canadian support for such standards, although, of course, it has no legal force.

Among the BEPS proposals classified as minimum standards, the only one (aside from certain country-by-country reporting procedures that clearly will be adopted) likely to be a priority for action in Canada is that relating to treaty shopping. Even before the BEPS initiative, Canada had been focused on fighting treaty shopping. In 2013, the Department of Finance released a consultation paper on treaty shopping, and the 2014 budget proposed for consultation a blueprint for a specific statutory anti-treaty-shopping rule. Questions were raised about how the proposed anti-treaty-shopping rule would interact with Canada's tax treaty obligations. There also were concerns about front-running on the BEPS project. As a result, the Department of Finance announced in the summer of 2014 that the treaty-shopping proposals would be suspended pending further work by the OECD on BEPS. Now that the final BEPS package has been released, short-listing treaty shopping among the minimum standards, it is expected that the Canadian government will restart its anti-treaty-shopping initiative. However, it is unclear what approach Canada will choose in light of the OECD's formulation of the minimum standard and the substantial concerns with the proposal in the 2014 federal budget.

It is also possible that amendments to the Canadian Tax Act may be proposed as a result of the OECD's work on the other action items underlying BEPS. In particular, two substantive areas that are of concern relate to so-called hybrid mismatch arrangements and interest deductibility. However, here the OECD's proposals have been labelled with the lower standard of "common approaches", and there has not been any indication by the Department of Finance that it is considering legislating in these areas.

2. Possible Judicial Developments

Following the Ontario Court of Appeal's decision in *Attorney General of Canada v Juliar* in 2000, courts across the common law provinces have permitted rectification of transactions where the transactions did not achieve specific tax objectives that the taxpayers intended to obtain in undertaking the transactions. In addition, the Supreme Court of Canada in *Québec v AES* and *Québec v Riopel* in 2013 permitted rectification of transactions governed by the *Civil Code of Québec*.

Obtaining rectification orders to correct tax mistakes has become quite common in Canada. However, the CRA appears to be of the view that the courts have unduly extended the concept of rectification in cases following the *Juliar* decision. The CRA challenged a number of rectification orders in 2015, which resulted in many reported cases. Some of the decisions were in favour of the taxpayer and some were not. Two of these cases were heard by the appeals courts: the Ontario Court of Appeal in *Fairmont Hotels v Attorney General of Canada* and the Québec Court of Appeal in *Groupe Jean Coutu (PJC) Inc. v Attorney General of Canada*. The Supreme Court of Canada has granted leave to appeal in both of these cases. It is possible that the Supreme Court will hear these cases in 2016 and provide what may be definitive guidance on the scope of rectification.

The Federal Court of Appeal may also hear the *Birchcliff* and *Barejo* cases in 2016. The results of both of those cases could have a significant impact on planning going forward.

II. U.S. TAX REVIEW AND OUTLOOK

A. 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.

1. 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.

2. 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).

3. 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.

4. 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.

B. 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.

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