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Canadian and U.S. Tax Laws: A Review of 2016 and a Look Ahead to 2017

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

I. CANADIAN INCOME TAX REVIEW AND OUTLOOK

A. Developments in 2016

1. *Legislative Developments*

The Liberal government's first full calendar year in office saw legislative changes advancing the new government's tax policy objectives and others furthering commitments made by the Harper government relating to international tax proposals by the Organisation for Economic Co-operation and Development (OECD).

The principal measures were announced as part of the 2016 federal budget, delivered on March 22, 2016. Our comments on these changes, including changes affecting switch fund shares, linked notes and debt parking, are available in our article 2016 Federal Budget: Tax Highlights. These proposals (with certain revisions) were included in draft legislation released on October 21, 2016, and received royal assent on December 15, 2016.

Eligible Capital Property Regime Ends

The year 2016 marked the end of the eligible capital property (ECP) regime, a long-standing feature of the *Income Tax Act* (Canada) (ITA) governing the treatment of goodwill and other intangible property with no fixed life. The ECP regime has been integrated into the existing capital cost allowance (CCA) regime in the ITA, effective January 1, 2017. Although the new rules provide deductions in computing income that are similar to those under the old ECP regime and offer a degree of simplification in this area, the change will have a significant impact on the sales of businesses by Canadian business. This is particularly true for those operating through Canadian-controlled private corporations (CCPCs) – essentially private Canadian corporations that are not controlled by non-residents and/or public companies. The gain on the sale of ECP will now be taxed as a capital gain and subject to the refundable tax anti-deferral mechanism applicable to investment income when realized by a CCPC. For a greater discussion of these changes, see Repeal of the Eligible Capital Property Regime.

Emissions Trading Regime

A new federal emissions trading regime begins for taxation years commencing after 2016. This regime establishes tax rules governing the use and sale of emission allowances by taxpayers that are regulated emitters. Under these rules, emission allowances received by such taxpayers are treated as inventory and are valued at their cost, rather than the "lower of cost or market" approach that generally applies to other types of inventory.

A regulated emitter does not include the receipt of an allowance in its income. When an emission allowance is used to settle an emission obligation, a taxpayer may deduct the cost of the allowance, and no gain or loss will be realized on the disposition of that allowance. Conversely, the sale of an emission allowance to a third party will result in a taxable income to the extent that the proceeds of the sale exceed the cost of the emission allowance. Identical allowances – that is, allowances that have essentially identical terms and can be used to settle the same emission obligation – are subject to a cost averaging rule. Other rules address the treatment of expenses deducted in respect of emission obligations that exist over a period of many years (resulting in a deduction-inclusion cycle in respect of the obligation), and the valuation of an emission allowance in the event of a change of control.

Expansion of 55(2) Anti-Avoidance Rule Enacted

Dividends paid by one Canadian corporation to another are generally received tax-free under the intercorporate dividends-received deduction (DRD). The availability of the DRD is subject to the anti-avoidance rule in subsection 55(2) of the ITA, which has historically prevented 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. 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. Notwithstanding the numerous submissions received by the Department of Finance expressing concerns with the proposals, they were enacted on June 6, 2016. Clearly, Finance is concerned about abuses of the DRD, evidenced in recent court cases in which challenges to highly structured transactions have been unsuccessful.

The scope of subsection 55(2) has been broadened to apply where a tax-free intercorporate dividend is paid (i) for the purpose of reducing or avoiding capital gains on the disposition of shares; or (ii) where one of the purposes of the dividend is (a) to effect a significant reduction in the fair market value of any share; or (b) to increase the cost of property of the dividend recipient. In addition, the long-standing exception from subsection 55(2) for dividends paid within a related group now applies only to a deemed dividend arising on a redemption or repurchase of a share. The new rules may materially impede the ability of taxpayers to undertake certain creditor-proofing transactions or even to implement ordinary movements of cash within their corporate groups. It has been hoped that through the development of administrative policies, the Canada Revenue Agency (CRA) would provide guidance to corporate groups that routinely move cash by way of dividends, but its comments to date have provided little comfort.

Alternative Basis for Assessment

There is a long-standing principle under Canadian tax law that the CRA may not advance an argument in respect of a disputed tax assessment after the end of the normal reassessment period if that would increase the amount of tax payable under the assessment. Recently, the Federal Court of Appeal in *Last v. The Queen* confirmed that in addition to the above principle, in positing alternative arguments, the CRA must treat each source of income separately and may not advance an alternative argument that would change the amount of tax payable in respect of any particular source of income (in *Last*, the Minister was prohibited from recharacterizing a capital gain as business income after the reassessment period). In response to that decision, subsection 152(9) of the ITA has been amended to permit the Minister to advance alternative arguments – after the end of the normal reassessment period – that may adjust the amount of taxes payable in respect of particular sources of income provided that the total amount of the assessment (from all sources) is not increased.

This change raises concerns for taxpayers required to comply with the large corporation rules, which, among other things, require a taxpayer to specifically identify each issue in a notice of objection and prohibit the raising of new issues at a later date. Unfairness may result if, during the objection process, an alternative basis for reassessment gives rise to a new issue to which the taxpayer did not originally object. This added flexibility afforded to the CRA may also interfere with the tax audit process by undercutting the usefulness of a limited waiver (a commonly used tool that extends the limitation period for a specified issue or issues to facilitate ongoing audit activity) if the CRA now has the ability to recharacterize an amount of income subject to the waiver as being from a different source than the issue to which the waiver relates.

Extension of the Back-to-Back Rules

In 2014, the Canadian government introduced detailed rules (often referred to as the “back-to-back” rules) to prevent the use of intermediaries to reduce withholding taxes on payments of interest to non-residents or to avoid the application of the thin capitalization rules by, for example, having a related non-resident deposit amounts with a financial institution that makes a loan to a Canadian group member. Effective January 2017, the back-to-back rules have been extended to apply to broader categories of inbound transactions and to certain outbound back-to-back transactions.

First, the aspect of the back-to-back rules intended to prevent the use of intermediaries to reduce withholding taxes was expanded by (i) extending their application to structures involving multiple intermediaries; (ii) extending their application to rents, royalties and similar payments (i.e., where there is no loan to a Canadian entity); and (iii) adding “character substitution” rules whereby the back-to-back arrangement to the intermediary involves shares or a lease, licence or similar arrangement rather than a loan. Payments made by Canadian residents under inbound investment structures should be carefully examined particularly in connection with the character substitution rules, which may apply where a non-resident holds shares of the intermediary on which the intermediary is obligated to pay dividends (the amounts of which are determined by reference to interest payments received) or which provide a redemption or retraction right. These new rules also may present significant issues in the context of arm’s-length leasing or licensing arrangements.

Second, the back-to-back rules have also been extended to outbound loans to capture circumstances in which a Canadian corporation attempts to circumvent the shareholder loan rules in the ITA by lending funds to an arm's-length person on condition that the person makes a loan to a shareholder of the corporation (or a connected person or partnership). Where they apply, the Canadian corporation will be deemed to have made a loan directly to the shareholder (or connected person or partnership) and the tax consequences associated with such a loan will follow. These rules have added additional complexity in the context of cash-pooling or notional cash-pooling arrangements involving Canadian and foreign group companies.

Tax Information Exchange

As a participant in the OECD work on base erosion and profit shifting (BEPS), the federal government has adopted country-by-country (CBC) reporting standards developed by the OECD for multinational enterprises (MNEs) in the OECD Report entitled *Action 13: Country-by-Country Reporting Implementation Package*. CBC reporting rules in the ITA apply to fiscal periods of MNE groups beginning on or after January 1, 2016, and are generally expected to apply where the group parent entity is resident in Canada and the group earns annual revenue of €750 million or more. Canada has also committed to spontaneous exchange of tax rulings with other tax administrations that started in 2016.

In addition, Canada has adopted the OECD's Common Reporting Standard (CRS) in new Part XIX of the ITA. The CRS, another product of the BEPS initiative, requires Canada to automatically exchange financial account information with foreign tax authorities and imposes certain due diligence procedures and reporting obligations on financial institutions to generate the required information. The CRS comes into effect on July 1, 2017.

Transfer Pricing and BEPS

In the 2016 budget, the Department of Finance, uniquely states that the CRA is now applying the revised OECD guidance on transfer pricing, which purportedly "provides an improved interpretation of the arm's-length principle." Significantly, however, it stated that the CRA will not adjust its administrative practices at this time in the two most controversial areas of the OECD's BEPS-related transfer pricing work: the proposed simplified approach to low-value-adding services and the treatment of so-called cash boxes that could affect outbound financings of foreign subsidiaries of Canadian multinationals. Canada will decide on a course of action regarding these measures after the OECD completes its follow-up work.

2. ***Judicial Developments***

Solicitor-Client Privilege

In *Canada (Attorney General) v. Chambre des notaires du Québec*, the Supreme Court of Canada considered the constitutionality of provisions in the ITA that permit the CRA to issue a requirement to provide documents or information in respect of a taxpayer to a third party and to enforce the requirement through a compliance order where the third party is a notary or lawyer. The dispute arose when the CRA issued requirements to Québec notaries to provide information regarding certain taxpayers that the notaries believed was protected by solicitor-client privilege (SCP). The CRA unsuccessfully argued at all levels of court that the requirements were valid on the basis of an accounting records exception in the definition of "solicitor-client privilege" in the ITA, which effectively states that accounting records of a lawyer are not communications that are protected by SCP.

The Supreme Court confirmed that SCP is a substantive rule of law and a principle of fundamental justice and must remain as close to absolute as possible. On this basis, the Court ruled that the impugned requirement provisions are unconstitutional and of no force and effect with respect to notaries and lawyers whose records are protected by SCP. With respect to the accounting records exception in the definition of SCP, the Court ruled that it is unconstitutional and invalid for all purposes because of the undue limits it places on SCP. In the companion case, *Canada (Minister of National Revenue) v. Thompson*, which arose in the context of the CRA's attempt to compel a particular lawyer to disclose documents from his law practice relating to particular clients, the Supreme Court affirmed its conclusion with respect to the unconstitutionality of the accounting records exception.

These decisions confirm the absolute nature of SCP and place clear limitations on the scope of information that the CRA can obtain using the requirement procedures in the ITA. Importantly, the Court noted that SCP is a right belonging to, and can only be waived by, a client, and that a lawyer or notary must be given the opportunity to assert SCP on behalf the client so that the client may determine whether an assertion of privilege will be maintained.

The Federal Court recently considered the scope of "common interest privilege" in the transactional context in *Iggillis Holdings Inc. v. Canada (National Revenue)* and concluded that common interest privilege was only available in the litigation context. Read our comments on this decision in Federal Court Refuses to Recognize Common Interest Privilege in the Transactional Context**.**

Interest Deductibility

In *TDL Group Co. v. The Queen,* the Federal Court of Appeal (FCA) confirmed that borrowed money used to make an equity investment in a subsidiary meets the test for interest deductibility under paragraph 20(1)(c) of the ITA, which requires that the funds be used for the purpose of earning income. The funds in question had been borrowed by the taxpayer (TDL) from a related non-resident corporation at interest and used to subscribe for additional shares in its subsidiary, Tim Donut U.S. Limited, Inc. (TDUS). TDUS in turn loaned the funds back to the group parent on an interest-free basis. The interest-free loan remained outstanding for seven months, after which TDUS transferred it to another entity that replaced it with an interest-bearing note. The Tax Court disallowed TDL's interest deduction for the seven-month period in which TDUS was not earning interest on its loan to the group parent. (The Tax Court considered only the interest payable over the initial seven-month period because the CRA had accepted the deductibility of that the interest after the period when the interest-bearing promissory note was put in place.)

The FCA reversed the decision, finding that the Tax Court erred in reading into the purpose test in paragraph 20(1)(c) a requirement that a taxpayer have a reasonable expectation of receiving income during the seven months in which the non-interest bearing loan was outstanding. The FCA held that the correct inquiry was determining TDL's purpose at the time it subscribed for the shares in TDUS. This approach meant that the reasoning of the Tax Court was flawed because it focused on the immediate indirect use of the funds rather than the purpose of the borrowing. The FCA's decision reaffirms that an equity investment in a subsidiary can qualify as having an income-earning purpose even where income may not immediately be realized.

Offshore Investment Fund Property

In *Gerbro v. R.*, the Tax Court of Canada considered whether investments in five offshore hedge funds constituted offshore investment fund property for purposes of subsection 94.1(1) of the ITA. The funds were corporate hedge funds and funds of funds that were managed in low-tax jurisdictions and generally invested in publicly traded securities, commodities or currencies. Subsection 94.1(1) applies where two conditions are met: (i) the taxpayer's investment derives its value primarily from portfolio investments in various assets (the Value Test); and (ii) it may reasonably be considered that one of the taxpayer's main reasons for making the investment was to reduce or defer Canadian taxes relative to a direct investment in the underlying assets (the Motive Test). Where it applies, the taxpayer is imputed a prescribed rate of return on the capital invested in the offshore funds. The CRA took the position that the taxpayer's investments were subject to subsection 94.1(1) and, as a result, substantially increased the taxpayer's income.

The Tax Court commented on both of these tests. For purposes of the Value Test, the Tax Court noted that the ordinary commercial meaning of "portfolio investment" is an investment in which the investor is not able to exercise significant control or influence over the property invested in. Indicators of a controlling stake in an investment included investment above a certain threshold and active involvement in management of the underlying operations. The Court also concluded that the term "portfolio investment" could include inventory of an active investment business.

With respect to the Motive Test, the Court indicated that it is not purely a subjective test and that a taxpayer's stated intention must be objectively reasonable and corroborated with factual evidence. The Motive Test is a "one of the main reasons" test and can be defeated by credible business reasons that demonstrate that obtaining a tax benefit was not one of the main reasons for a particular investment. The Court noted that the purpose of section 94.1 is to achieve capital export neutrality by ensuring that a taxpayer's decision to invest offshore is a neutral decision that is not tax-driven.

Although the particular funds met the Asset Test, the Tax Court allowed the taxpayer's appeal on the basis that the Motive Test under subsection 94.1(1) had not been met because none of the taxpayer's main reasons for investing in the funds was to defer or avoid Canadian taxes. Rather, clear evidence was presented to the Court demonstrating that compelling business reasons, including the reputation of the respective fund managers, drove the decision to invest in those particular funds. *Gerbro* contains instructive commentary regarding the purpose of section 94.1, and sets out a helpful framework for analyzing its application. *Gerbro* is currently on appeal to the FCA.

Rectification

Historically, rectification in common law jurisdictions was granted in limited circumstances in which the parties had reached a prior agreement, but the document evidencing the contract did not reflect the terms of the agreement.

A broader form of rectification was allowed in the Ontario Court of Appeal's 2000 decision in *Juliar v. Canada (Attorney General)*, which permitted rectification of a transaction where the transaction did not achieve the specific tax objective that the taxpayer had intended in undertaking the transaction. 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*.

After the *Juliar* decision, obtaining rectification orders to correct tax mistakes has become quite common in Canada. However, in reasons released on December 9, 2016, the Supreme Court of Canada tightened the criteria for obtaining rectification by siding with the government in the common law rectification case *Canada (Attorney General) v. Fairmont Hotels Inc.* and its companion civil law rectification case *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*. The decision of the majority in *Fairmont* overruled the Ontario Court of Appeal's decision in *Juliar*. The extent of the impact of these decisions on the availability of rectification for tax matters moving forward remains to be seen.

B. Outlook for Canadian Tax Developments in 2017

1. ***Changes to 30% Rule for Pension Plan Investments***

Federal legislation governing pension funds and their subsidiaries limits the ability of these entities to invest in shares of a corporation having more than 30% of the votes for the election of the directors of the corporation (the 30% Rule). This rule originated when pension funds were generally limited to passive investments and took no active role in the businesses in which they invested. However, changes in market conditions and the manner in which Canadian pension funds invest have prompted reconsideration of the need for this rule.

In the 2015 federal budget, the federal government announced its intention to review the 30% Rule. Further to that announcement, in June of 2016 it held a public consultation (see Pension Plan Investment in Canada: The 30 Per Cent Rule) in which it invited interested parties to make submissions regarding the policy behind the 30% Rule, the potential risks resulting from its abolishment and whether additional legislation may be required to reduce the effect of such risks. The Department raised the question whether associated tax changes would be appropriate in the context of any change to the 30% Rule. Comments were due on September 16, 2016, and 19 submissions have been published on the government website. No further information has been released to date. It is hoped that the government's response will be communicated in 2017.

The federal government's consultation followed the Ontario government's announcement in 2015 that it would eliminate the 30% Rule for Ontario regulated pension plans (see Ontario Proposes Abolishing the Pension Fund "30% Rule"). The Ontario government has not, to date, eliminated the Ontario 30% rule.

2. ***Ratification of the OECD Multilateral Instrument***

In the 2016 budget, the government noted that amendments to Canada's tax treaties to include a treaty anti-abuse rule could be achieved through bilateral negotiations, the multilateral instrument that would be developed in 2016, or a combination of the two.

On November 24, 2016, members of an ad hoc group consisting of more than 100 jurisdictions under the aegis of the OECD concluded negotiations of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). The MLI, developed through the BEPS process, is intended to be an instrument that can be used to uniformly and efficiently implement recommendations regarding tax treaty policy and practice across thousands of bilateral tax treaties between participating jurisdictions. The key provisions are aimed at (i) targeting certain "hybrid mismatch arrangements" by denying treaty benefits in certain circumstances and introducing an optional tie-breaker rule; (ii) preventing treaty abuse by introducing a principal purpose test and a limitation-on-benefits provision; (iii) preventing the artificial avoidance of permanent establishment (PE) status by lowering the PE threshold in certain circumstances; and (iv) improving dispute resolution between jurisdictions by introducing minimum standards for the mutual agreement procedure.

The MLI opened for signature on December 31, 2016, and will enter into force after it has been ratified by at least five countries. The instrument allows signatories to select among various options in respect of many of its provisions, and each country must choose which set of options it wishes to apply, which rights it intends to reserve and which of its tax treaties will be covered by the MLI. The MLI is intended to provide a streamlined process for the implementation of these BEPS measures and to avoid the lengthy bilateral negotiations between individual jurisdictions that would be required if proceeding treaty by treaty.

If Canada chooses to adopt the MLI, Parliament must ratify it before its provisions become binding in Canada. The Department of Finance was heavily involved in the negotiation of the MLI but has stated that it has not determined which aspects of the MLI it will adopt. It has stated that a government decision on which items it will adopt might be reported by the time of the next federal budget. It is expected that 2017 will bring about further developments in this regard, and provide some evidence more generally on whether the MLI will be widely adopted and whether it has in fact materially simplified the implementation of BEPS into bilateral tax conventions. A looming question in this regard is the position of the United States with respect to the MLI, because it is widely considered not to look favorably on a multilateral approach that is inconsistent in any material way with its own approach to tax treaties.

II. U.S. TAX REVIEW AND OUTLOOK

A. Review of U.S. Tax Developments in 2016

The tax reform wish list in the Obama administration's budget for 2016 was generally similar to the administration's list for 2015. Congress, however, failed to enact any comprehensive tax reform (or any other significant tax legislation) this year.

The Internal Revenue Service (IRS) spent most of 2016 pushing through various regulatory initiatives in a last-ditch effort to address certain perceived abuses before the end of President Obama's term. At times the regulatory initiatives seemed extreme, although the IRS did show a commendable willingness to scale back some of the most controversial measures. As the year drew to a close, the pace of IRS activity increased, with much of the year's regulatory output appearing in the last three months of 2016. As described further below, projects with an international focus included new rules on intercompany debt and equity, inversion transactions, transfers of goodwill to foreign corporations, cash-rich spinoffs, leveraged partnership structures and bottom-dollar guarantees, limitations on the foreign tax credit, foreign currency transactions, and the application of exceptions to withholding under the *Foreign Investment in Real Property Tax Act* (FIRPTA).

The courts continued to rule sporadically in tax cases, especially in transfer pricing cases. Unfortunately, the long-awaited Tax Court decision in the *Grecian Magnesite* case, on whether a sale of a partnership interest can generate effectively connected income, is (still) pending.

A brief review of tax developments in 2016 precedes our outlook for 2017.

1. ***Tax Legislation***

No significant tax legislation was enacted in 2016.

2. ***Administrative Developments***

The IRS issued several significant guidance items in 2016. Most of these regulatory projects addressed transactions that the IRS perceives as abusive, such as inversions or cash-rich spinoffs. As the new administration prepares to take office, these regulations may be the outgoing administration's last chance to pursue its aggressive anti-tax-avoidance agenda.

Intercompany Debt-Equity Rules

The IRS's most controversial achievement in 2016 was finalizing regulations under section 385 of the Internal Revenue Code of 1986, as amended (the Code) that recharacterize certain intercompany debt instruments as equity for U.S. tax purposes. The IRS issued a proposed version of the regulations in April, which were immediately criticized as being overbroad and outside of its scope of authority. The public submitted numerous critical comments on the proposed regulations, and members of Congress even called for the repeal or at least the delay of the regulations.

The IRS responded by issuing final regulations (and related temporary regulations) on October 13, 2016 (the section 385 regulations). The final regulations were a retreat from the aggressive rules provided in the proposed regulations in several ways, including by adding a broad exemption for all debt issued by foreign corporations. This is one instance in which the IRS acted quickly to respond to taxpayers' concerns and produced a regulatory package more closely tailored to the transactions that the IRS was targeting.

The general rule of the section 385 regulations is that debt issued by a corporation to an affiliate is recharacterized as equity if the debt is issued in connection with (i) a distribution to shareholders, (ii) an exchange for stock of an affiliate or (iii) certain exchanges for property in an asset reorganization (these three groups of transactions are referred to here as Specified Transactions). Under a provision known as the "funding rule," debt issued by a corporation to an affiliate is also recharacterized as equity if the debt is issued with a principal purpose of funding a Specified Transaction.

The section 385 regulations also include a "per se rule" under which certain debt issuances are presumptively treated as subject to the funding rule. Under the per se rule, any issuance of debt during the 72-month period beginning 36 months before, and ending 36 months after, the date of a Specified Transaction is treated as having been issued with a principal purpose of funding the Specified Transaction.

The regulations contain several exceptions to the rules described above. Among these, the amount of any Specified Transaction is reduced by the earnings and profits of the corporation that issues the applicable debt. In addition, the rules described above do not apply to the first $50 million of debt issued by a corporation, to short-term debt or to funding new investments through a controlled subsidiary.

The effective date of the section 385 regulations is January 19, 2017. The final regulations also include a transition rule under which debt issued after April 4, 2016 (i.e., the issue date of the proposed section 385 regulations) will remain subject to the funding rule, even if it is refinanced before the effective date of the final section 385 regulations.

For further discussion of the section 385 regulations, see IRS Proposes Broad Limit on Intercompany Debt and Final U.S. Debt-Equity Regulations Are Not as Sweeping as Feared.

Anti-Inversion Guidance

On April 8, 2016, the IRS issued new regulations to combat inversion transactions (see IRS Issues Tough New Anti-Inversion Regulations). These regulations are generally more aggressive than the previous anti-inversion rules, which were provided in IRS notices released in 2014 and 2015.

When a domestic entity is transferred to a foreign corporation in an inversion transaction, the tax consequences are determined by the percentage of such foreign corporation that is owned immediately after the inversion transaction by owners of the domestic entity immediately before the inversion that received shares of the foreign corporation as a result of being an owner of the domestic entity. If that percentage is at least 60% but less than 80%, then special taxes apply to the inverted entity; if that percentage is at least 80%, the foreign corporation is treated as a domestic corporation for all tax purposes.

Several of the new provisions affect how the 60% and 80% thresholds are calculated. For instance, in calculating whether a particular domestic acquisition is an inversion, certain stock of the foreign corporation is disregarded if it was previously issued in connection with another domestic entity acquisition within the preceding 36 months.

The new rules have been the subject of practitioners' criticism on account of the rules' increased scope in comparison with the rules provided in either of the IRS notices from 2014 and 2015. In particular, some commentators have claimed that the new rules may in some instances have retroactive effect and accordingly exceed the IRS's authority. As discussed further below, on August 4, 2016, the U.S. Chamber of Commerce filed a lawsuit in the Western District of Texas challenging the IRS's authority to issue a rule that aggregates certain transactions in determining whether the percentage thresholds have been exceeded.

Rules on Contributions of Goodwill to Foreign Corporations

On December 15, 2016, the IRS released final regulations on the contribution of goodwill and certain other intangibles by U.S. persons to foreign corporations. The final regulations replace temporary regulations that were issued in 1986 and proposed regulations from September 2015.

Generally, contributions of property to a corporation in exchange for corporate shares is tax-free if the U.S. person is in control of the corporation after the contribution. However, in the case of a contribution of property by a U.S. person to a foreign corporation, the Code denies tax-free treatment unless an exception applies. Prior law included an exception to this rule, under which tax-free treatment would not be denied in the case of a contribution of goodwill to a foreign corporation. The new regulations eliminate this exception. The new rules generally apply to transfers that take place on or after September 14, 2015.

Limits on Cash-Rich Spinoffs

On July 14, 2016, the IRS proposed new regulations on tax-free spinoffs (see U.S. Proposes Further Limits on Spinoffs). For a spinoff to be tax-free, each of the distributing and the controlled corporations must have had an active business for the previous five years, and the distribution must not be a device for the distribution of corporate earnings and profits (in addition to meeting numerous other requirements). The new rules refine the active business and device tests.

Under the active business test, the new rules provide that the active business must constitute at least 5% of the total assets of the distributing and controlled corporations. This rule is intended to discourage "cash-rich" spinoffs whereby most of the assets of the controlled corporation are passive assets.

The new rules add a number of objective tests to evaluate whether a spinoff is a device. Under the former rules, the device test was a "facts and circumstances" test that was difficult to apply. The new regulations add a per se rule to the device test, under which a spinoff is automatically treated as a device if the proportion of each corporation's assets that are non-business assets exceeds certain thresholds.

Guidance on Recently Enacted FIRPTA Exemptions

One of the most significant developments of 2015 was the enactment of the *Protecting Americans from Tax Hikes Act* (the PATH Act). The PATH Act included several new exemptions from FIRPTA for foreign institutional investors, which were clarified in certain respects by a package of regulations that were released on March 7, 2016. One significant provision of the regulation describes how a qualified foreign pension fund (a QFPF) certifies that it is exempt from FIRPTA withholding by providing a FIRPTA certificate to a person who buys a U.S. real property interest from the QFPF. Unfortunately, the IRS has not issued guidance with respect to many other issues raised by the PATH Act, such as how a foreign investment fund can be designated as a "qualified collective investment vehicle" (QCIV) for the purpose of identifying "qualified shareholders" for the new exemption from FIRPTA.

Further guidance on the exemption for QFPFs and the designation of foreign entities as QCIVs (and other similar items on the IRS's current Priority Guidance List) may become less of a priority under the new administration because they primarily benefit foreign investors.

Tax Information Exchange

On June 29, 2016, the IRS issued final regulations on country-by-country reporting that are consistent with Action 13 of the OECD's BEPS project. The final regulations require companies with annual revenue of $850 million or more to report certain information, including amounts of profit, loss and accumulated income, on a country-by-country basis. The IRS is expected to exchange the resulting data with other countries that participate in country-by-country reporting, although the IRS can stop sharing with any country that permits public disclosure of the data.

Guidance on Partnership Liabilities

On October 3, 2016, the IRS issued a package of final and proposed regulations limiting the use of leveraged partnerships, which are structures used to allow investors to take cash out of certain U.S. businesses on a tax-free basis.

Generally, a partner who contributes property to a partnership and receives a related distribution of money or other property is treated as if he or she sold the contributed property to the partnership in a "disguised sale." Under prior law, a partner could avoid disguised sale treatment by using a leveraged partnership structure. The leveraged partnership structure permitted the distribution of cash from a partnership to the partner without triggering a disguised sale if the distribution was funded with partnership debt and a portion of that debt was allocated to the distributee partner under liberal rules for allocating recourse liabilities. The new regulations treat all of a partnership's liabilities as non-recourse liabilities for the purposes of the disguised sale rules (but not for other purposes), shutting down leveraged partnership opportunities.

In addition, the IRS limited the ability of partners to use "bottom-dollar guarantees" to cause partnership debt to be treated as recourse debt.

These regulations are generally effective as of October 5, 2016. A special transition rule provides that certain partners whose share of liabilities exceeds their adjusted basis in their partnership interests can continue to rely on the existing rules for a limited period of time.

Limitation on the Availability of Foreign Tax Credits

On December 6, 2016, the IRS released complex rules that limit foreign tax credits with respect to income or gain realized in connection with a "covered asset acquisition." The new rules generally apply to acquisitions that take place after December 7, 2016.

A covered asset acquisition is generally a transaction that creates additional basis for U.S. tax purposes, but not for foreign tax purposes. Such transactions, in the eyes of the IRS, could lead to a taxpayer enjoying foreign tax credits with respect to income that will never be subject to U.S. federal income tax.

These regulations are generally broader than their predecessors. The new regulations even create new categories of covered asset acquisition, including (i) transactions treated as asset acquisitions for U.S. tax purposes and the acquisition of partnership interests for foreign tax purposes, (ii) distributions of property from partnerships that result in an increase in the basis of the distributed property for U.S. tax purposes but not for foreign tax purposes, and (iii) transactions that are treated as asset acquisitions under both U.S. and foreign law but which result in an increase in the assets' basis for U.S. tax purposes but not for foreign tax purposes.

Regulations on Foreign Currency Transactions

The IRS issued extensive and detailed regulations on December 7, 2016, that provided long-needed guidance on determining the gain or loss of a "qualified business unit" (QBU). A QBU is a subdivision of a business entity that keeps its books in a particular currency. The guidance provides rules on how to account for gains and losses associated with foreign currencies, including on a termination of a QBU. The new rules on foreign currency transactions generally apply with respect to tax years beginning in 2018, although taxpayers may elect to apply the new rules starting in 2017.

This particular regulatory package is so complex that the Trump administration might make an example by suspending or withdrawing these rules.

New Disclosure Rules for Limited Liability Companies

The IRS finalized regulations on December 13, 2016, that create a new information reporting obligation for disregarded entities owned by a single foreign owner (see IRS Issues Broad Disclosure Rules for Foreign-Owned Disregarded U.S. Entities). Previously, a foreign person could conduct business or investment activities through a domestic disregarded entity (such as a single-member LLC that is not treated as a corporation for U.S. federal tax purposes) without identifying itself to the IRS. The new rule, generally effective for the 2017 tax year and later, requires a domestic disregarded entity to disclose its owner on IRS Form 5472. This requirement is likely to become a "trap for the unwary" or at least a major headache for foreign persons that hold assets through domestic disregarded entities.

PFIC Guidance

On December 28, 2016, the IRS published final regulations on determining indirect ownership and reporting requirements of passive foreign investment companies (PFICs). The new regulations provide an "anti-duplication" rule providing that stock shall not be counted twice in determining whether a person is considered an indirect owner of a PFIC held by a domestic corporation in which the person also has an interest. In addition, the IRS provided guidance on how shareholders of PFICs should complete IRS Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," and IRS Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations." These regulations are effective as of December 28, 2016.

3. ***Updates on Tax Cases***

Several cases in U.S. and European courts are of interest.

Grecian 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), any gain recognized by a foreign person when he or she 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 Code trumps the position of the IRS on this issue. We expected to see a decision on *Grecian Magnesite* in 2016, but the Tax Court has not yet issued a ruling.

Transfer Pricing Cases

The IRS has been especially active in transfer pricing litigation in 2016. The increased caseload may be a reflection of the IRS's strategy of aggressively pursuing multinational corporate taxpayers in advance of the Trump inauguration.

In *U.S. v. Microsoft Corp.*, the IRS is attempting to impose a $38-billion adjustment to Microsoft's income in a transfer pricing dispute. The case has generated a significant controversy resulting from the IRS's use of a private law firm in its prosecution of the case. The IRS bases such use of outside counsel on regulations that were finalized on July 12, 2016. The legality of the IRS's use of outside counsel is central to Microsoft's defence in the case. Moreover, the U.S. Chamber of Commerce and other trade groups have publicly opposed the regulations, and Senator Rob Portman of Ohio has introduced legislation that would prohibit the IRS's use of outside law firms. Senator Portman's legislation was passed by the Senate Finance Committee on April 20, 2016, but no action has been taken on it since then. So far, the court has allowed the proceedings to continue with the IRS's outside counsel.

Another important transfer pricing case currently pending is *Amazon.com, Inc. v. Commissioner*. The case concerns the transfer of intangibles to a Luxembourg subsidiary through a cost-sharing arrangement that the IRS claims was done at a massive undervaluation. At stake in the case is a $2.2-billion adjustment to Amazon's income. Amazon's transfer pricing arrangements with Luxembourg are also the subject of a state aid investigation by the European Commission, discussed below.

The IRS lost one closely followed transfer pricing case, *Medtronic, Inc. v. Commissioner*. This case also concerned a medical device manufacturer's transfer of intangible assets to a foreign affiliate, this time in Puerto Rico. In this case, however, the IRS attacked royalty payments with respect to the intangibles on the grounds that the Puerto Rican affiliate was an assembly plant as opposed to an independent manufacturer. Alternatively, the IRS argued that the royalty payments should have been taxable under the Code's corporate tax provisions. The Tax Court disagreed with the IRS, finding that the Puerto Rican subsidiary was involved in all aspects of the manufacturing process.

Court Challenge to Inversion Rules

In *Chamber of Commerce v. I.R.S.*, the U.S. Chamber of Commerce is suing the IRS to challenge a rule that would aggregate multiple transactions in order to subject corporations to the anti-inversion rules. The lawsuit claims that the Treasury Department and the IRS exceeded their authority granted by Congress under the Code in issuing the new rule, and that the Treasury Department and IRS violated federal law by not providing an adequate notice and comment period for taxpayers before the new regulations were issued. The government is likely to challenge the Chamber of Commerce's standing to bring the case.

European State Aid

On December 19, 2016, the European Commission issued its final ruling in its €13-billion state aid investigation of Apple Inc. The European Commission ruled that tax benefits granted by the Irish government to Apple were impermissible state aid and that Apple must repay the amount of the benefit to Ireland. The controversy could have general implications for U.S. multinational corporations that have benefited from tax breaks in the European Union, such as Starbucks in the Netherlands, and Amazon and Fiat in Luxembourg.

The U.S. Treasury Department has issued a white paper criticizing the European Commission's state aid investigations, claiming that the investigations represent second-guessing of individual member states' internal tax determinations and that the investigations violate E.U. law because the recoveries sought would be retroactive. The white paper, in turn, has attracted criticism on the grounds that the Treasury Department is acting on behalf of U.S. companies and should not be instructing Europe on how to interpret its own laws.

Apple and Ireland have announced that they intend to appeal the European Commission's ruling.

4. *Updates on Tax Treaties*

We noted in last year's update that the United States has not ratified a tax treaty since 2010, and several treaties have been held up in the ratification process through the efforts of Senator Rand Paul, who objects to provisions in the treaties that allow the sharing of financial information between tax authorities. There was no change in the treaties' prospects during 2016. Treaties awaiting ratification include those with Switzerland, Japan, Luxembourg, Chile, Hungary, Spain and Poland. Senator Paul was re-elected in November, which suggests that his opposition to the signed but unratified treaties is not going to end soon.

On February 17, 2016, the Treasury Department released a revision of its Model Tax Treaty. The revised version includes provisions that were released individually in 2015, with some modifications, as well as some new changes to the articles on interest, dividends, royalties and other income. The practical implications of the Model Tax Treaty are difficult to predict in light of the current backlog of unratified tax treaties in the Senate.

The ratification process for the MLI (described in our discussion of Canadian tax developments, above) has begun internationally. U.S. Deputy Assistant Treasury Secretary for International Tax Policy Robert Stack has indicated that the most attractive provision of the MLI for the United States is the mandatory binding arbitration provision, although he also said that "it may well be that a future administration will decide that we are just better off going out and doing the arbitration on our own bilaterally."

The United States is not expected to sign on to the MLI, since most of the policies motivating the MLI are already incorporated into its existing tax treaties. The final decision on whether to adopt the MLI will be made by the Trump administration.

B. Outlook for U.S. Tax Developments in 2017

The most significant development for anticipated tax reform in the United States in 2017 is the election of Donald Trump as the next president. The tax policies that Trump advocated during his campaign suggest that the next few years may be favourable for taxpayers, and especially for high-net-worth taxpayers. Nevertheless, it is difficult to predict with any accuracy which specific proposals may be put forth by the new administration.

The fact that the Republicans control both Congress and the White House suggests that tax legislation may have a greater chance of passing than it did during the relatively gridlocked years of the Obama administration. In particular, comprehensive tax reform seems to have been made a priority for Republicans in 2017, so the chances for comprehensive tax reform are greater than they have been in many years.

Commentators have looked to the Republican Tax Reform Blueprint (the Blueprint), published on June 24, 2016, for clues as to the types of tax reforms that could be included in Trump's tax reform package. The Blueprint advocates three main categories of reform: (i) equalizing the treatment of imports and exports through the institution of a "cash-flow tax" on imports into the United States; (ii) encouraging repatriation of foreign earnings by adopting a territorial system of U.S. taxation; and (iii) simplifying the international tax rules, particularly with respect to Subpart F. Although there appears to be significant academic support for the proposals, commentators express concern that the measures described in the Blueprint may violate the WTO's prohibition against border tax adjustments or other trade agreements.

The following list describes some of the key tax prospects under the incoming Trump administration.

1. ***International Tax Reform***

International tax reform that affects U.S. multinationals is likely to be pursued, although some provisions might encourage foreign direct investment as a side effect.

- Trump previously proposed to end all offshore tax deferral, with a 10% one-time charge on previously deferred earnings. Alternative proposals include a minimum tax on foreign earnings or a territorial exemption for business income.

- Such proposals would affect the bottom line on companies' financial statements, but at least the "book income hit" would apply equally across the board.

- Rate reductions would eliminate much of the incentive to engage in inversion transactions, and removal of offshore tax deferral would wipe out most transfer pricing concerns.

- Trump claims that tax-advantaged "dumping" from regimes with a VAT could be neutralized if the United States adopts its own VAT. This could be a solution to the drop in tax revenue caused by some of Trump's other reforms, although some may advocate for a VAT to be accompanied by refundable credits to lower-income individuals to offset the VAT's regressivity.

- The United States is not likely to tax foreign investors at higher tax rates directly, so a reduction in tax rates would help foreign investors as well.

2. ***Lower Tax Rates***

In an environment in which tax rates are falling, many taxpayers will try to defer taxation, accelerate deductions and enter into instalment sales. Since Trump will be in office for a maximum of eight years, "good times will roll" in tax planning during this period of time. Trump is basing his tax plan on a maximum ordinary income tax rate for individuals of 33%, maximum long-term capital gains rate of 20% and a maximum business tax rate of 15%, both for corporations and passthrough entities. In addition to lowering tax rates, Trump is also likely to seek to eliminate the 3.8% Obamacare tax on net investment income and the entire alternative minimum tax.

Ironically, if the income of passthrough businesses is taxed at a lower rate than investment income under a Trump administration, “dealer income” will become more tax efficient than “trader income.”

If passthrough businesses are taxed at a lower rate on long-term capital gains, there will no longer be an incentive to do away with the current taxation of carried interest. Both parties, however, support closing the carried interest loophole, so the passage of this provision seems relatively likely (as it has for almost a decade).

3. ***Loopholes***

Like many politicians, Trump has voiced an intention to eliminate common tax “loopholes.” The following provisions could be targeted:

- *Charitable contribution deductions*. Although any attempt to curb these deductions could hurt the not-for-profit sector.

- *Itemized deductions*. A limit or cap on value of itemized deductions could cause taxpayers to include investment and personal expenses on their business books (e.g., as “substantiated reimbursements”).

- *Benefits to the real estate industry*, such as like-kind exchanges, master limited partnerships, and REITs. Although real estate investors have traditionally enjoyed numerous tax advantages, such benefits are low-hanging fruit for tax reformers.

4. ***Phase-out of Interest Deductions***

One source of revenue that Trump has announced would be a gradual elimination or cap on deductions for business interest expenses. Such a measure would likely lead to a massive deleveraging of the economy. Taxpayers may be well-advised to consider increasing their debt levels now to take advantage of any grandfather provisions in any phase-out legislation.

5. ***Wealth Planning***

Opportunities for wealth planning are expected to burgeon under the Trump administration. Accordingly, proposed regulations on the valuation of assets for estate and gift tax purposes may not be finalized. In addition, the lifetime estate and gift tax exemption could be expanded, possibly to $10 million per person or more. Alternatively, gift and estate taxes could be repealed entirely, as Trump promised, and replaced with an income tax at death (much like Canada’s) with a $10-million *de minimis* gain exclusion.

6. ***Infrastructure Investment Incentives***

Investment in infrastructure, a concern that motivated the passage of the PATH Act last year, might not find any additional stimulus through the federal tax system, but we would not be surprised to see an increase in tax-favoured bonds, an extension of renewal energy credits, or similar measures.

7. ***Fewer Regulations***

Although Trump is said to be against regulation generally, we would be surprised to see a repeal of most of the recent regulations described above. In addition, regulatory reform may reasonably be expected to precede any tax legislation, in light of the process for accomplishing each and taking into account their impact on budgeting for future legislation.

8. ***Macroeconomic Considerations***

While economists have acknowledged that the impact of Trump's policies on the U.S. dollar is difficult to determine, economic theory suggests that the dollar would strengthen absent unchecked inflation. Inflation, however, would solve many fiscal problems (outside of the tax system).

- Inflation would support a pay-down of the national debt. The current Treasury Department has denied that there would be a wave of refinancing in anticipation of inflation. During his campaign, Trump suggested that increasing inflation could be a strategy to support the renegotiation of the national debt.

- A corresponding increase in returns would keep retirees out of the job market, which would keep the unemployment rate low. In addition, an increase in returns would benefit low-rate debt issuers, at least in the short term.

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), Marie-Emmanuelle Vaillancourt (514.841.6543) or Michael Kandev (514.841.6556) in our Montréal office; or Peter Glicklich (212.588.5561) or Gregg M. Benson (212.588.5508) in our New York office.

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