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Coca-Cola Wins on Foreign Tax Credits in Tax Court

On December 14, 2017, the Tax Court granted summary judgment in favor of Coca-Cola, holding that the company was entitled to nearly $139 million in Mexican foreign tax credits. *The Coca-Cola Co. & Subsidiaries v. Commissioner*, 149 T.C. No. 21 (Dec. 14, 2017). The foreign tax credit issue arose as a correlative issue to the IRS's transfer pricing adjustment to royalties due to Coca-Cola's U.S. operations for the foreign operation's use of intangible property under a license. *See, e.g.*, "Tax Court Swiftly Rejects IRS Argument That Closing Agreement is Not Relevant in USD 3.3 Billion Transfer Pricing Case," Baker McKenzie North America Tax News and Developments, Volume XVII, Issue 10, November 2017. Coca-Cola and the IRS had reached an agreement on the royalties for the 1987-1995 period and entered into a closing agreement covering those years. From 1996 to 2006, Coca-Cola applied the same approach as set forth in the closing agreement for determining the appropriate royalties, and the IRS only audited the transfer pricing to assure that Coca-Cola properly applied the methodology of the closing agreement.

In 2011, the IRS notified Coca-Cola that it would adjust the royalty income that Coca-Cola reported for 2007 through 2009 in an audit of Coca-Cola's 2007-2009 tax years. The IRS abandoned the methodology of the closing agreement and made large section 482 adjustments to the royalties paid by certain Coca-Cola foreign affiliates to Coca-Cola U.S., including Coca-Cola's Mexican operations. The IRS designated the case for litigation and issued a notice of deficiency making a number of adjustments including the transfer pricing adjustments and the Mexican foreign tax credit adjustment.

Coca-Cola has been operating in Mexico via a licensee since 1950. During 2007-2009, Coca-Cola operated in Mexico through a disregarded entity such that the income earned by and foreign taxes paid by the Mexican operations were reported on the Coca-Cola consolidated tax return. Since 1998, Coca-Cola applied the closing agreement methodology for royalties paid by its Mexican operations. For the 2001-2006 period, Coca-Cola entered into two unilateral advance pricing agreements with the Mexican government adopting the same methodology for determining the royalties that the Mexican licensee paid to Coca-Cola U.S. In 2007-2009, Coca-Cola relied on a Mexican tax advisor's advice that the closing agreement royalty methodology provided an arm's length result and that the Mexican tax authority would not permit a higher royalty amount to be paid.

Upcoming Tax Events

[Partnership Tax for the Corporate Practitioner (Including Tax Reform)]

Chicago, IL
▶ April 19, 2018

[Doing Business Globally]

Mexico City
▶ April 25, 2018

[15th Annual Global Tax Planning and Transactions Workshop]

New York, NY
▶ May 23, 2018

[Baker McKenzie and Bloomberg BNA Global Transfer Pricing Conference]

Washington, DC
▶ June 7-8, 2018

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

The IRS disallowed nearly $139 million of foreign tax credits claimed by Coca-Cola for the taxes paid by the Mexican subsidiary to the Mexican government following the transfer pricing adjustment to the Mexican royalty. First, the IRS argued that the tax payments were not compulsory levies because the Coca-Cola Mexican subsidiary's tax liability would have been lower had the company adopted the IRS's view of the arm's length royalty rate (which was significantly higher than the rate produced by Coca-Cola's methodology and was the principal issue in the case). Second, the IRS argued that the company failed to exhaust its administrative remedies to reduce its Mexican tax liability. The two arguments relate to the requirements of the Treasury Regulations about whether a foreign tax payment is a compulsory levy. The Tax court summarized the requirements of Treas. Reg. § 1.901-2(c)(5)(i) as follows:

> Two requirements must be satisfied in order for a foreign tax payment to be considered "compulsory." First, the payment must be "determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the *** provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax." Ibid. Second, "the taxpayer [must] exhaust[] all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax." Ibid.

The Tax Court rejected both arguments. First, the Tax Court held that Coca-Cola's position was a reasonable interpretation of Mexican tax law with respect to the appropriate royalty payment to be paid by the Coca-Cola Mexican subsidiary to Coca-Cola U.S. In this regard, the Tax Court cited the two advance pricing agreements and Coca-Cola's reliance on advice from a Mexican tax advisor. Second, the Tax Court found that Coca-Cola did not have any administrative remedies to reduce its Mexican tax liability. Thus, it was unreasonable to expect Coca-Cola to agree to the IRS's proposed adjustments before the resolution of the transfer pricing case. Specifically, the Tax Court cited to the section 905(c) mechanism for making foreign tax credit redeterminations as a reason why any change to the Mexican tax liability was premature. Additionally, the Tax Court noted that the IRS denied Coca-Cola's request for competent authority relief related to the Mexican taxes. While the taxpayer has won for now, the issue is ultimately dependent on the outcome of the primary transfer pricing issue.

By: Robert Walton and Cameron Reilly, Chicago

Leveraged Cash Proceeds Purge: PLR 201802007

On January 12, 2018 the Internal Revenue Service (the "IRS") released PLR 201802007, in which it found that a distributing corporation's debt repayments and stock repurchases in relation to a public spinoff would be treated as a distribution pursuant to a plan of reorganization pursuant to Code Section 361(b), and that the conversions of various entities to single-member limited liability companies, followed by their contributions to a newly–formed controlled corporation, would be treated as complete liquidations under Code Section 332.

Starting Facts

The distributing entity ("Distributing") was a publicly–traded corporation and the common parent of an affiliated group of corporations filing a consolidated return. Distributing and its subsidiaries operated two lines of business, Business 1 and Business 2. Business 1 was operated through various domestic entities, some of which were treated for tax purposes as corporations ("Regarded Entities"), and others of which were treated as disregarded entities and a partnership (all such entities, collectively, the "Business 1 Entities").

Proposed Transactions

Distributing proposed a spinoff of Business 1 to its public shareholders, with some additional financing transactions integrated as part of the overall plan, and it requested certain rulings on the tax-free treatment of those transactions. The steps involved in the spinoff were set forth as follows. First, Distributing would form a new subsidiary ("Controlled"). Next, the Regarded Entities (excluding Distributing itself) would convert into wholly–owned limited liability companies (the "Conversions"), and subsequently would be treated as disregarded entities (the "Converted Entities"). Controlled would then borrow from a third party, after which Distributing would contribute the Business 1 Entities, along with any related liabilities, to Controlled in exchange for a combination of Controlled stock and cash. After the exchange, Distributing would distribute the stock of Controlled pro rata to its shareholders (the "Distribution").

Following the Distribution, after a certain number of months, Distributing intended to use the cash it received in the exchange to pay down existing Distributing debt held by third parties (the "Debt Repayments"). In the event that the Debt Repayments settled enough of Distributing's liabilities with cash still left over, the excess cash would then be used to redeem outstanding Distributing stock (the "Stock Repurchases"). The Stock Repurchases would be made pursuant to a stock buyback program created at the time of the Distribution. The letter ruling refers to this combination of the Debt Repayments and the Stock Repurchases as the "Cash Proceeds Purge."

Representations

In issuing the ruling, the IRS relied on the following three representations. First, Distributing's debt to be repaid with the cash proceeds received in the exchange would not exceed the weighted quarterly average of Distributing's debt for the 12-

month period preceding the date on which Distributing's board of directors initially discussed the spinoff. Second, after Distributing completed the Debt Repayments using the cash proceeds, it would not renew those debts on the same terms and from the same lenders. Finally, neither Distributing nor Controlled had any plan or intent to transfer, in the aggregate, a certain percentage of the fair market value of their assets in the Converted Entities to another corporation.

Rulings

The IRS ruled that, assuming the proposed transactions otherwise qualified under Code Sections 368(a)(1)(D) and 355, for purposes of Section 361(b), the Cash Proceeds Purge would be treated as being distributed pursuant to the plan of reorganization of the spinoff transaction. Furthermore, notwithstanding that the Conversions would occur immediately prior to the Converted Entities' contributions to Controlled, the Conversions would qualify as complete liquidations under section 332.

Section 361(b) permits a corporation that exchanges its property for stock or securities in another corporation (which exchange would, by itself, qualify for nonrecognition treatment under Code Section 361(a)) also to receive, in certain circumstances, other property or money without the recognition of gain. The corporation receiving the other property or money must distribute such other property pursuant to the plan of reorganization. Under section 361(b)(3), this distribution requirement may be satisfied if the recipient corporation transfers the money or other property received in the exchange to its creditors. In the context of a Section 355 spinoff with a section 368(a)(1)(D) asset transfer, however, this provision also requires that the value of other property and money transferred to creditors not exceed the adjusted bases of assets transferred to the controlled corporation (less any liabilities assumed).

Thus, the IRS determined that the Cash Proceeds Purge -- consisting of both the Debt Repayment and the Stock Repurchases -- satisfied the distribution of other property requirement set forth in section 361(b). However, the taxpayer was required to represent that the debt amount would not exceed certain limits, and that the cash would not effectively be "circled back" by Distributing's re-upping its previous borrowings.

Additionally, certain of the Business 1 assets made their way into Controlled by, first, becoming directly owned by Distributing via the Conversions of regarded corporations into the Converted Entities (single-member limited liability companies), and, second, being contributed to Controlled via transfers of the Converted Entities. Here the IRS remained consistent with prior letter rulings in which it did not, in the context of the reincorporation of assets in a controlled corporation as part of a section 355 spinoff, recast the section 332 liquidation treatment as a liquidation-reincorporation (which would instead be treated as the reorganization of the liquidated assets in another corporation, resulting in the transfer of the liquidated corporation’s tax history and attributes as well). *See*, *e.g.*, PLR 201633014 (Aug. 12, 2016); PLR 201315016 (Apr. 12, 2013).

By: Mike Tenenboym, Chicago

IRS's LB&I Division Releases Five New Transfer Pricing Directives

On January 12, 2018, the IRS's Large Business and International ("LB&I") division released five new transfer pricing directives (hereinafter individually referred to as "Directive" and collectively referred to as "Directives") to LB&I division employees. These five Directives provide additional insight into LB&I's transfer pricing examination procedures and policies. Because a significant amount of LB&I resources are devoted to transfer pricing issues, the goal of the Directives is to "manage transfer pricing issues under examination and related resources in the most efficient and effective manner possible."

The five Directives relate to:

1. The mandatory transfer pricing information document request ("IDR");
2. The imposition of Code Section 6662(e) transfer pricing documentation penalties;
3. An instruction to LB&I division employees to no longer develop adjustments to a taxpayer's cost sharing arrangement ("CSA") based on changing the taxpayer's multiple reasonably anticipated benefit ("RAB") shares to a single RAB share when subsequent platform contribution transactions ("PCTs") are added to an existing CSA;
4. An instruction to no longer open issues related to stock-based compensation included in a CSA's intangible development costs ("IDCs") until the Ninth Circuit issues an opinion in *Altera*; and
5. The procedures necessary to change a taxpayer's selection of a Treas. Reg. § 1.482 transfer pricing method.

The Mandatory Transfer Pricing IDR

On January 22, 2003, the LB&I's predecessor organization issued a directive requiring examiners to request a taxpayer's section 6662 transfer pricing documentation at the joint opening conference of an audit cycle. If a taxpayer did not produce its section 6662 transfer pricing documentation, the directive instructed examiners to issue an IDR requesting the taxpayer's section 6662 transfer pricing documentation (commonly referred to as, "the Mandatory Transfer Pricing IDR").

While the Directive retains the Mandatory Transfer Pricing IDR, LB&I examiners are instructed to issue the Mandatory Transfer Pricing IDR only in limited circumstances. First, the Mandatory Transfer Pricing IDR will be issued if an LB&I campaign instructs the issuance of a Mandatory Transfer Pricing IDR. Second, if an examination shows "initial indications of transfer pricing compliance risk" and the LB&I exam team is staffed by a Transfer Pricing Practice and/or Cross Border Activities employee, then the Mandatory Transfer Pricing IDR will be issued. According to the Directive, in all other examinations, "the Mandatory Transfer Pricing IDR will not be issued."

The obvious questions to the Directive are two-fold. First, because public guidance on LB&I campaigns remains limited, how will taxpayers know whether a particular LB&I campaign requires a Mandatory Transfer Pricing IDR? Second, how will a taxpayer know whether the LB&I exam team believes the taxpayer's transfer pricing operations show "initial indications of transfer pricing compliance risk"? It is unlikely for a large multinational corporation to believe its own transfer pricing operations show transfer pricing compliance risk. While taxpayers may welcome the Directive's limitations on the issuance of the Mandatory Transfer Pricing IDR, taxpayers are reminded to continue to document their transfer pricing operations for purposes of section 6662(e) penalty protection.

Section 6662(e) Transfer Pricing Documentation Penalties

Treasury regulations require the IRS to apply penalties when the taxpayer fails to create or timely provide section 6662(e) transfer pricing documentation or when the taxpayer's section 6662(e) transfer pricing documentation is unreasonable or inadequate. The Directive emphasizes to LB&I employees the adverse consequences when the exam team doesn't assert section 6662(e) transfer pricing documentation penalties. LB&I exam teams are reminded to use a "legislative tool intended to encourage taxpayer compliance." In addition, the section 6662(e) transfer pricing documentation penalty incentivizes taxpayers to provide adequate and timely transfer pricing documentation. According to the Directive, "[a]ppropriate application of penalties when documentation is inadequate maintains accountability and encourages reasonable and well-documented return positions that may be assessed more efficiently, saving resources for both the IRS and taxpayers."

The Directive also reminds taxpayers that providing section 6662(e) documentation does not in-and-of-itself protect taxpayers against penalties. For a taxpayer to afford themselves of the reasonable cause exception to the penalty regulations, taxpayers must document that they reasonably selected the best method for their transfer pricing analysis and they reasonably applied that best method to their transfer pricing operations. The Directive advises that a taxpayer's section 6662 transfer pricing documentation is inadequate and unreasonable in the following circumstances: (1) "inaccurate inputs"; (2) "failure to adequately search for or consider material information"; (3) "failure to follow the best method rule in selecting and applying the method"; and (4) "results that differ significantly from the arm's length result and that are sizeable in relation to the controlled transaction."

The assertion of a section 6662(e) transfer pricing documentation penalty requires the LB&I manager's written approval, "ideally when the penalty is initially raised and, if not completed earlier, before the issuance of a 30-day letter or notice of deficiency." The LB&I manager's written approval must be maintained in the taxpayer's case file.

Multiple RAB Share Calculations in CSAs

The IRS often examines a taxpayer's RAB share calculations used in its CSA. One fact pattern that requires a taxpayer to consider its RAB share calculations is when a US participant in a CSA acquires an independent company with valuable intangible property and then makes that intangible property available to the foreign participant through a subsequent PCT contribution to the CSA. The Directive provides three different potential RAB share ratios that could be used in this fact pattern: (1) the existing RAB shares used in the CSA; (2) the shares of incremental profits related to the intangible property that is made available to the CSA by the subsequent PCT contribution; and (3) updated RAB shares based on the combination of the newly acquired intangible property and the existing intangible property covered by the CSA.

Because the IRS has not developed an IRS-wide position on the issue, the Directive instructs LB&I employees to "not develop adjustments based solely on changing a taxpayer's multiple RAB shares to a single RAB share for subsequent PCTs." However, the Directive continues to advise LB&I employees to "examine whether the multiple RAB shares used by the taxpayer are appropriate given all the specific facts and circumstances."

Stock-Based Compensation in a CSA's IDCs Not An Examination Issue Until *Altera* Appeal Is Resolved

On July 27, 2015, the Tax Court issued an opinion in *Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015), invalidating Treasury's cost sharing regulations under section 482 requiring parties to a qualified CSA to include stock-based compensation costs when determining operating expenses. In applying the Administrative Procedure Act and the Supreme Court's precedent in *Motor Vehicles Mfrs. Ass'n v. State Farm*, 463 U.S. 29 (1983), the Tax Court held that the regulations were procedurally invalid because Treasury and the IRS issued the regulations in an arbitrary and capricious fashion. The Tax Court and the Ninth Circuit invalidated a 1995 version of similar regulations in *Xilinx Inc. v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). The government appealed the Tax Court's decision in *Altera* to the Ninth Circuit and oral argument was heard in October 2017.

Because of the appeal in *Altera*, the Directive instructs LB&I employees to not open new examinations of CSA stock-based compensation issues. The LB&I division will reconsider the Directive's instructions once the Ninth Circuit issues an opinion in *Altera*. Importantly, the Directive is limited to not opening *new* examinations of CSA stock-based compensation issues. According to the Directive, if a CSA stock-based compensation issue is already being developed by the LB&I exam team, and the taxpayer agrees to extend the statute of limitations for a period long enough to allow for the decision in *Altera* to be known and allow for any additional development work, then the CSA stock-based compensation issue development work will be stopped. However, if the taxpayer does not agree to extend the statute of limitations as stated above, then the LB&I exam team will continue to develop the issue.

The Directive is welcome news for taxpayers who may be subject to an LB&I exam team willing to open a new CSA stock-based compensation issue. However, for taxpayers currently subject to an examination of a CSA stock-based compensation issue, the Directive requires taxpayers to make a strategic decision whether to extend the statute of limitations to allow for the decision in *Altera* and any necessary additional development work.

Approval Required by the Treaties and Transfer Pricing Operations ("TTPO") Transfer Pricing Review Panel Before Changing a Taxpayer's Best Method Selection

The final Directive relates to the approval process required when an LB&I exam team determines that a method other than the taxpayer's section 482 method would result in a more reliable measure of an arm's length result. If an LB&I exam team determines an alternative section 482 method is warranted by the specific facts and circumstances, then the LB&I exam team must submit a recommendation through the issue manager's management chain to the applicable Director of Field Operations level for referral to the national TTPO Transfer Pricing Review Panel. The same approval process is required when an Advance Pricing Agreement ("APA") team within the Advance Pricing and Mutual Agreement ("APMA") program determines that a method other that the taxpayer's section 482 method produces a more reliable measure of an arm's length result. However, if the assigned APA team has already begun formal negotiations with a competent authority on a bilateral APA, then the approval process discussed above is not required.

The TTPO Transfer Pricing Review Panel consists of the Transfer Pricing Practice Director or APMA Director, a Senior Advisor to the TTPO Director, and the Income Shifting Practice Network Manager. The TTPO Transfer Pricing Review panel's analysis will focus on the following: (1) why the taxpayer's method is unreliable; (2) whether the taxpayer's method can be adjusted to make it more reliable; and (3) if not, what method is more reliable, and why. Importantly, the approval process discussed above does not apply if the LB&I exam team or the APA team changes the *application* of the taxpayer's section 482 best method, and not the *selection* of the best method.

Concluding Remarks

On the LB&I Directive's website, the IRS states, "LB&I Directives provide administrative guidance to LB&I examiners to ensure consistent tax administration on matters relating to internal operations. The Directives do not establish IRS position on legal issues and are not legal guidance." However, taxpayers subject to transfer pricing audits are encouraged to use the five new Directives as an informational guide during current and future audits. Taxpayers can expect LB&I employees to generally follow the Directives during a transfer pricing audit.

The five Directives can be located at the following link: *https://www.irs.gov/businesses/corporations/large-business-and-international-lbi-industry-director-guidance.*

By: *Cameron Reilly,* Chicago

More Partnership Audit Regulations

On February 2, 2018, Treasury and IRS issued Proposed Regulations, effective as of December 31, 2017, addressing the manner in which a partnership and its partners take into account for tax purposes an “imputed underpayment.” An imputed underpayment generally is an increase to the amount of income tax owed by the current partners of a partnership as a result of a federal tax audit. The audit rules allow either the partnership to directly pay an imputed underpayment, or the partnership may elect to cause the partners to pay such amount. Consistent with these options, the Proposed Regulations address how to account for imputed underpayments under each approach. If a partner transfers its interest to a successor partner, the new partner steps into the shoes of the original partner for purposes of the imputed underpayment.

Entity Level Payments

If the partnership pays the imputed underpayment, the Proposed Regulations require the partnership to make notional adjustments with respect to its “specified tax attributes.” These complex adjustments are designed to essentially give the partners proper credit for the fact that the partnership essentially paid their tax liability and to try to put things back in the same place as if the denied tax benefit had never been taken. The adjustments cover the partnership’s tax and book basis of its assets, Code Section 704(c) amounts, and the partners’ outside bases and capital accounts. Adjustments to specified tax attributes can only be made with respect to a partnership’s existing assets. For example, if an imputed underpayment arises because the IRS denies $50 of depreciation deduction, the partnership must create a $50 notional item of income that increases the tax and book basis of the property for which the depreciation was incorrectly computed. That notional item is treated as income and the partnership allocates it among the partners. Because the notional item is a “tax only” item, it cannot be allocated in a manner that has substantial economic effect. However, the Proposed Regulations will deem the allocation to have substantial economic effect if it is allocated in the same manner that it would have been allocated in the year to which it relates.

Special procedures determine the appropriate amount of the tax liability arising from the notional item of income, and how that liability is borne by each partner. For example, if one partner is tax-exempt, its allocable share of the notional item will not give rise to a tax liability, and specifically, the partnership computes its imputed underpayment consistent with the partners’ aggregate tax liability taking into account each partner’s tax status (e.g., if a partner is tax-exempt, the imputed underpayment should account for that partner having no liability). The tax liability arising from the notional item is computed using the attributes of the reviewed year partner for the year in which such party was a partner, even though that partner may have since transferred its partnership interest. For example, if a tax-exempt partner transfers its interest to a taxable partner, the calculations are based on as if the tax-exempt partner was receiving the adjustment.

Because the partnership will pay what would have been a partner tax if reported correctly, conceptually the partner should be in the same place as if the partnership would have originally distributed the cash and the partner had paid its liability. Because the theoretical distribution would have lowered the partner's outside basis, the Proposed Regulations treat the partnership-level payment as causing a notional non-deductible expenditure pursuant to section 705 that reduces each partner's outside basis. The section 705 item should be allocated to the partners consistent with their share of the imputed underpayment. Anti-abuse rules prevent allocating the Section 705 basis adjustments in a manner that would shift the tax liability among partners (e.g., specially allocating all non-deductible section 705 basis adjustments to a single partner when that partner did not bear the full burden of the imputed underpayment).

Section 6226 Push-Out Payments

With respect to section 6226 push-out payments, the Proposed Regulations create a notional item of income that the partnership allocates among its partners. Because the push-out moves the responsibility for payment to the partners, there is no need for a downward section 705(a)(2)(B) adjustment to create basis parity, and the partners will increase their outside bases to reflect the notional item. A push-out payment made by a pass through partner is treated with respect to that pass through partner, and its ultimate partners, in the same manner as an entity level payment described above.

By: Sam Kamyans, Washington, DC

The Fate of the Physical Presence Nexus Standard

Just over a month ago, the U.S. Supreme Court surprised many in the state tax community when it announced that it granted *certiorari* in *South Dakota v. Wayfair, Inc.*, Docket No. 17-494; appealed from 901 N.W.2d 754 (S.D. 2017). Granting *cert.* in *Wayfair* means that the U.S. Supreme Court may be willing to overturn precedent that, for over fifty years, has provided and continues to provide a bright-line physical presence nexus standard applicable to states' ability to impose sales and use taxes. *See National Bellas Hess Inc. v. Illinois*, 386 U.S. 753 (1967), affirmed in part by *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The U.S. retail economy and its transition from brick-and-mortar storefronts to e-commerce retailers have thus been shaped by the expectation that physical presence within a taxing state is required before that state may impose sales or use taxes on a retailer.

For better or worse, the physical presence standard has eroded significantly in recent years, as states have enacted legislation or promulgated regulations – ranging from expansive agency, affiliate, or "click-through" nexus provisions to use tax notice and reporting requirements – to recover revenue allegedly lost from the application of the physical presence nexus threshold to out-of-state retailers. In the wake of the 2016 Direct Marketing Association ("DMA") decision from the Tenth Circuit Court of Appeals, some states enacted use tax notice and reporting measures for retailers that do not collect sales tax. Under these measures, such out-of-state retailers that meet certain sales thresholds to in-state customers are required to notify both the in-state customers of their use tax obligations and the state's Department of Revenue of the identities and amounts purchased by the in-state customers (e.g., Colorado, Louisiana, Pennsylvania, Rhode Island, Vermont, and Washington). *See Direct Marketing Assn. v. Brohl*, 814 F.3d 1129 (10th Cir. 2016). *See also States on the Verge of a Nexus Showdown, April 22, 2016, and The End is Just the Beginning: Implications of the DMA Settlement, March 14, 2017, for our prior coverage*. These use tax notification requirements can create a heavy compliance burden for retailers, and some states also impose significant penalties for noncompliance. This onerous combination has caused many out-of-state retailers to opt out of the use tax notification and reporting requirements by electing to collect sales tax, even if they do not have any in-state physical presence.

The DMA case, which made its way through the U.S. Supreme Court before the Tenth Circuit's decision, also effectively kicked off the so-called "kill *Quill*" movement with U.S. Supreme Court Justice Kennedy's 2015 concurrence stating that "[t]he legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*." *Direct Marketing Assn. v. Brohl*, 135 S.Ct. 1124, 1135 (2015) (J. Kennedy concurrence). States have responded to Justice Kennedy's invitation. Several states adopted "kill *Quill*" measures, whereby out-of-state internet retailers that meet certain sales and/or transactional thresholds to in-state customers are required to collect and remit sales tax to the state – a result designed to directly contradict the physical presence nexus standard. *See Is the "Kill Quill" Movement Gaining Momentum, April 4, 2017; The Possible Upshot of South Dakota's Master Plan to "Kill Quill", December 28, 2016; and Massachusetts Promulgates Controversial Remote Vendor Nexus Regulation; Virginia E-Commerce Retailer Files Suit Protesting Constitutional Overreach, October 30, 2017, for our prior coverage*.

South Dakota's Economic Nexus Legislation and the US Supreme Court's Prerogative

South Dakota is one of the states to respond to Justice Kennedy's invitation, and it has achieved its goal of having the U.S. Supreme Court reexamine the physical presence nexus standard applicable to sales and use taxes. South Dakota enacted S.D. Codified Laws § 10-64-2 ("SD Economic Nexus Legislation"), effective May 1, 2016, which extended the obligation to collect and remit South Dakota sales tax to certain retailers with no physical presence in the state. Specifically, retailers (1) with gross revenue of over $100,000 per calendar year derived from sales to South Dakota customers; or (2) with 200 or more separate transactions to South Dakota customers in a calendar year are treated as if they had a physical presence in the state.

Following the enactment of the SD Economic Nexus Legislation, South Dakota commenced a declaratory judgment action in circuit court, requesting a declaration that three e-commerce retailers without a physical presence in the state must comply with the legislation. *See South Dakota v. Wayfair, Inc., Overstock.com, Inc., and Newegg, Inc.*, Docket No. 32CIV16-000092 (S.D. Cir.

Ct. 2017). *See also [South Dakota and Alabama Hatch Newegg Challenges to Quill, June 29, 2016](), for our prior coverage*. The retailers filed a motion for summary judgment arguing the law directly conflicts with *Quill* and is unconstitutional under the Commerce Clause. The circuit court granted the retailers' motion, and, on appeal, the Supreme Court of South Dakota affirmed, properly holding that "*Quill* remains the controlling precedent on the issue of Commerce Clause limitations on interstate collection of sales and use taxes. We are mindful of the [U.S.] Supreme Court's directive to follow its precedent when 'it has direct application in a case' and to leave to that Court 'the prerogative of overruling its own decisions.'" *Wayfair*, 901 N.W.2d at 761 (Internal citations omitted). Now, the U.S. Supreme Court has found it appropriate to consider whether it should exercise its prerogative or let the physical presence standard live.

Better for the Physical Presence Standard to Burn Out? Or Fade Away?

If the U.S. Supreme Court wanted the physical presence standard to stand until Congress enacted superseding legislation, it could have sent a loud message to other states adopting unconstitutional economic nexus measures by flatly denying South Dakota's petition for *certiorari*. The U.S. Supreme Court declined to do so. Therefore, the significance of the U.S. Supreme Court granting *certiorari* in *Wayfair* cannot be understated, and, frankly, it does not bode well for the continuing viability of the physical presence standard as established by the judiciary, considering that at least three of the current U.S. Supreme Court Justices may have telegraphed their intentions in prior decisions.

First, Justice Thomas, in a dissent, has stated that the Dormant Commerce Clause – the basis for the physical presence nexus standard – ". . . has no basis in the text of the Constitution, makes little sense, and has proved virtually unworkable in application. . . . I think it worth revisiting the underlying justifications for our involvement in the negative aspects of the Commerce Clause, and the compelling arguments demonstrating why those justifications are illusory." *Camps Newfound / Owatonna v. Town of Harrison*, 520 U.S. 564, 610 (1997) (J. Thomas dissent).

Second, when *DMA* was before the Tenth Circuit, Justice Gorsuch – then a judge of the Tenth Circuit Court of Appeals – was critical of the bright-line physical presence standard in his concurrence, noting that ". . . *Quill* invited states to impose comparable [use tax notification] duties . . . . encouraging states over time to find ways of achieving comparable results through different means" and that " . . . *Quill's* very reasoning . . . seems deliberately designed to ensure that *Bellas Hess*'s precedential island would never expand but would, if anything, wash away with the tides of time." *Direct Marketing Assn. v. Brohl*, 814 F.3d 1129, 1151 (10th Cir. 2016) (J. Gorsuch concurrence).

And third, but certainly not least, as noted above, Justice Kennedy's concurrence in *DMA* sparked the "kill *Quill*" movement. His concurrence further noted that "[t]here is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently 'substantial nexus' to justify imposing some minor tax collection duty, even if that business is done through mail or the Internet. After all, 'interstate commerce may be required to pay its fair share of state taxes.'"   *Direct Marketing Assn. v. Brohl*, 135 S.Ct. 1124, 1135 (2015) (J. Kennedy concurrence) (Internal citations omitted).

It remains to be seen whether such a powerful case will be made and how the U.S. Supreme Court will rule in *Wayfair*. But even if the taxpayer prevails, it may simply be delaying the inevitable result articulated by Justice Gorsuch above. That is, even if the physical presence nexus standard were upheld for sales and use tax purposes, it may then instead be destined to die a slower death through states adopting onerous use tax notification and reporting requirements and penalty regimes, designed to persuade internet retailers to collect sales tax.

But all is not lost. In *Quill*, the U.S. Supreme Court upheld the bright-line test of *Bellas Hess*, noting that, "This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. . . . Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. In this situation, it may be that the better part of both wisdom and valor is to respect the judgment of the other branches of the Government." *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (Internal quotations and citations omitted). Congress passed federal tax reform; it just might be able to handle a workable solution for the states too.

By: John Paek, Palo Alto and Drew Hemmings, Chicago

End of Offshore Voluntary Disclosure Program

On March 13, 2018, the US Internal Revenue Service (IRS) announced that it will end the 2014 Offshore Voluntary Disclosure Program (OVDP) on September 28, 2018, but it will continue the following programs: Streamlined Filings Compliance Procedures, the Delinquent FBAR Submission Procedures and the Delinquent International Information Return Submission Procedures. Taxpayers with undisclosed foreign financial assets should consult with their US tax advisors before termination of the OVDP, which is designed for taxpayers whose noncompliance may be due to willful conduct or who could be subject to criminal tax penalties. To participate in the OVDP before its closes, taxpayers must submit a standard form disclosure letter and attachments providing information on their undisclosed foreign financial assets, as well as the financial institutions or intermediaries associated with such assets, and the materials must be received or post-marked on or before September 28, 2018. For a more thorough discussion of the OVDP, please see the Baker McKenzie Client Alert, "*End of Offshore Voluntary Disclosure Program*," distributed on March 19, 2018.

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Pennsylvania's Questionable Response to Federal Tax Reform's Full Expensing Provision

The Pennsylvania Department of Revenue (the "Department") recently announced its position with respect to immediate expensing under IRC section 168(k) adopted by the Tax Cuts and Jobs Act of 2017 ("Federal Tax Reform"). In short, in Pennsylvania Corporation Tax Bulletin 2017-02 (Dec. 22, 2017) (the "2017 Bulletin"), the Department explained that taxpayers are not entitled to a state-level depreciation deduction for property that is fully expensed under Code Section 168(k). This position is a departure from the Department's prior interpretation of Pennsylvania law, as stated in Pennsylvania Corporation Tax Bulletin 2011-01 (Feb. 24, 2011) ("2011 Bulletin"). In the 2011 Bulletin, the Department adopted a taxpayer-friendly position in light of the 2010 Tax Relief Act, thereby allowing the full benefit of 100% immediate expensing under section 168(k) to flow through to taxpayers for Pennsylvania corporate income tax purposes. Not surprisingly, legislation (H.B. 2017) has been proposed to reverse the Department's position in the 2017 Bulletin. If enacted, the legislation would allow an additional state-level depreciation deduction equal to the amount of depreciation that would otherwise be allowed under federal tax reform.

For more discussion on Pennsylvania's response to full expensing under section 168(k), please see the SALT Savvy blog post from February 12, 2018, *Pennsylvania Bill Seeks to Reverse Department's Questionable Position On Full Expensing*, available at http://www.saltsavvy.com/.

Getting Better All The Time…Baker McKenzie Adds New Talent to its Tax Controversy Group in New York

Baker McKenzie is pleased to announce the arrival of Erin Gladney as tax partner to our New York office. With more than 10 years of experience, Erin has represented taxpayers at all stages of tax controversies, including audit, IRS administrative appeals, trial, and appellate court review involving a broad range of international and domestic tax issues.

Erin's practice focuses on representing taxpayers on complex corporate tax matters involving substance-over-form issues, economic substance, step-transaction doctrine, debt-equity characterization, financing and leasing transactions, post-trial tax computations, statute of limitations issues, civil tax penalties, transfer pricing, evidentiary privilege issues, and summons enforcement. Her experience with IRS administrative proceedings includes the representation of taxpayers in examination and IRS Appeals including preparation of company employees for IRS interviews and presentations, IDR responses, and advising clients pre-audit to ensure evidentiary privileges are maintained and defenses to expected challenges are properly documented.

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Erin has significant experience in all aspects of tax controversy, in the litigation, trial, and appeal of major corporate cases. She has worked with clients to develop trial strategies, and performed direct examinations of fact and expert witnesses. Erin has prepared testifying fact and expert witnesses for examination at depositions and trial, and negotiated with opposing counsel regarding stipulations of facts, discovery issues, and post-trial tax computations.

Erin earned her J.D. from Northwestern University School of Law in and her B.A. from New York University.

We are excited to welcome Erin to the North America Tax Practice and look forward to sharing the breadth of her practice to our many clients across the region!

Tax News and Developments is a periodic publication of Baker McKenzie's North America Tax Practice Group. The articles and comments contained herein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases. Past performance is not an indication of future results.

Tax News and Developments is edited by Senior Editors, James H. Barrett (Miami) and David G. Glickman (Dallas), and an editorial committee consisting of Glenn G. Fox (New York), Gwen Hulsey (Houston), Joseph A. Myszka (Palo Alto), John Paek (Palo Alto), Alex Pankratz (Toronto), Julia Skubis Weber (Chicago), Angela J. Walitt (Washington, DC), and Robert S. Walton (Chicago).

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

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