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Is Congress Making Progress Towards Tax Reform? Or Are Congressional Republicans Moving Further Apart?

When this article went to press, Senator McConnell had delayed the Senate vote on the health care bill because there was not enough Republican support for its passage and the bill was on life support. However, the experience passing health care legislation out of the House of Representatives demonstrates that compromise on major legislation is often achieved at the last minute.

While the Senate tries to pass a health care bill before the August recess, the House Ways & Means Committee has turned its attention back to tax reform and held three hearings on the subject in May.

The first two hearings were generally intended to lay a foundation for the importance of tax reform and get input from Nina Olson, the National Taxpayer Advocate, on improving customer service from the IRS. (See *Hearing on How Tax Reform Will Grow Our Economy and Create Jobs* and *Hearing with the National Taxpayer Advocate*. These hearings were not particularly newsworthy, but served as a useful reminder to the committee that the business community seeks comprehensive, permanent tax reform. The third hearing focused on the Border Adjustment Tax (BAT). (*See Hearing on Increasing U.S. Competitiveness and Preventing American Jobs from Moving Overseas*). Although the witnesses at the third hearing generally supported the BAT, both Brian Cornell, Board Chairman and CEO of Target, and Kimberly Clausing, an economics professor from Reed College, testified against the BAT. Mr. Cornell's testimony focused on how the BAT would impact Target, its employees, and its customers, and he noted that the BAT would more than double Target's current effective tax rate ("ETR") from 35% to 75%, that prices on everyday essentials could be increased by up to 20%, and that currency adjustments are an "unproven and untested economic theory."

Although Chairman Brady continues to advocate for the Blueprint, he acknowledged that retailers have legitimate concerns about the BAT and, several days after the hearing, he proposed including a five-year transition period for implementing the BAT and providing "special treatment" with respect to the BAT for financial services, communications, insurance, and digitally-focused companies on the theory that determining cross-border transactions for these industries is more difficult. Chairman Brady apparently decided on these proposed changes without any input from his fellow Republican members of the Committee, and the changes don't appear to have changed any minds about whether to support the BAT. It's notable that Chairman Brady is already negotiating with himself about the scope of such a key provision in the Blueprint before draft legislative language has been released. It appears that Chairman Brady recognizes that in its current form, the BAT may not pass out of Committee.

Upcoming Tax Events

Wealth Management Briefing

Miami, FL
►July 26, 2017

Global Transfer Pricing Workshop

San Francisco, CA
► July 28, 2017

Tax Planning and Transactions Workshop

Minneapolis, MN
► September 7, 2017

Fifth Annual TEI / Baker McKenzie Tax Workshop

Austin, TX
►September 12, 2017

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

In addition to Chairman Brady's modifications designed to increase support for the provisions,), it's important to remember that the Trump administration has not supported the BAT, and numerous Republican senators have been vocal in criticizing the BAT. Despite all this, taxpayers should not assume the BAT is dead on arrival—it raises a significant amount of revenue and members of Congress have yet to build consensus around a revenue-raising alternative. Additional Ways & Means committee hearings on tax reform are expected in July, although they have not yet been scheduled.

The Senate Committee on Finance is also continuing to work on tax reform. On June 16, 2017, Chairman Hatch asked for feedback on tax reform. For business taxes, he would like proposals on: (1) "Strengthening businesses – both large and small – by lowering tax rates and broadening the relevant tax base in order to put the economy on a better growth path and create jobs;" and (2) "Updating our international tax system in order to make our nation more competitive in the global economy and preserve our tax base." Chairman Hatch also established partisan working groups to consider various tax reform proposals. Senators Enzi (R-WY) and Portman (R-OH) will focus on international tax, while Senator Grassley (R-IA) will focus on the individual system. Senators Heller (R-NV) and Cassidy (R-LA) will address energy tax issues. While this process is important for creating a committee product, it is unclear how it affects the tax reform negotiations between the House, Senate and White House. Meanwhile, Secretary Mnuchin, Gary Cohn, and other representatives of the Trump administration continue to meet with Republican members of Congress to develop a single Republican tax reform bill. Timing is uncertain, although the latest statements from the administration indicate that taxpayers should not expect to see a draft tax reform proposal before Labor Day.

While there are plenty of items competing for Congress' attention—from health care to reaching the debt limit to investigations into alleged Russian interference in the 2016 election—members of the Ways & Means and Senate Finance committees are focused on continuing their work on tax reform. Moreover, if the Senate is unable to pass a health care bill this summer, there will be increased pressure for Congressional Republicans to enact tax reform in 2017 so they can claim a legislative "win" during the 2018 campaign season. Clients who wish to participate in the tax reform process should develop a legislative engagement strategy (if they have not already done so) and share their views with Congress this summer. By the fall, Congressional Republicans and the Trump administration may have reached agreement on the broad parameters of tax reform and taxpayers who have waited to engage may find themselves in a defensive position.

By Alexandra Minkovich and Joshua D. Odintz, Washington, DC

IRS Refuses to Allow a Long Term Capital Loss on the Sale of a Subsidiary's Stock

On April 21, 2017, the IRS Office of Chief Counsel released CCA 201716045, which concluded that a corporate taxpayer was not entitled to long term capital loss treatment on the sale of its subsidiary's Class A stock. The CCA is interesting, not because of its ultimate conclusion—denial of a purported long term capital loss, but rather because of its underlying determination. Specifically, the CCA advised that the stock in question constituted Code Section 351(g)(2)(A) nonqualified preferred stock ("NQPS") even though the terms of the instrument technically allowed the holder of the stock to participate in corporate growth, a feature typically not found in NQPS.

In the CCA, the taxpayer, a domestic corporation (P), acquired the stock of an unrelated company (Sub 2) and contributed the Sub 2 stock to P's existing wholly owned subsidiary, Sub 1. In exchange for the Sub 2 stock, Sub 1 issued to P shares of its Class A stock, Class B stock, and a note payable. The taxpayer reported the transaction as a section 351 exchange.

The Class A stock involved a complicated set of rights and features that, in broad strokes, entitled its holder(s) to: (i) elect one director; (ii) quarterly preferred, floating rate, and participating dividends; (iii) upon liquidation, receive the stock's stated value, dividends in arrears, and a participating redemption premium based on a fixed percentage of the common stock's appreciation; and (iv) seniority over both the holders of the Class B stock and common stock with respect to general and liquidating distributions. The taxpayer took the position that the Class A stock did not constitute NQPS because the stock was legally entitled to participate in any corporate growth experienced by Sub 1 and therefore did not constitute "preferred stock" within the meaning of section 351(g). The taxpayer reached this conclusion despite the fact that Sub 1 was in poor financial condition and that financial advisors engaged to value the Class A stock estimated that the stock would generate a "negligible amount" of participating dividends over its lifetime.

Shortly after the contribution, P sold the Class A stock to Shareholder (which, although not identified in the CCA, appears to be a direct shareholder of P), resulting in what P reported as a long term capital loss. The CCA notes that Shareholder was also concerned with Sub 1's financial health, so much so that it demanded additional fees and collateral as a condition for the sale.

Following the sale of the Class A stock, Sub 1 made a single payment to Shareholder, which Sub 1 designated as a participating dividend, even though no dividends were paid on the common stock or Class B. In this regard, the CCA also notes that, in each of the three years prior to and the two years following the contribution and sale, Sub 1 incurred net losses, had negative retained earnings, and paid no dividends.

Section 351(g) provides that NQPS will be treated as "other property," rather than stock of the transferee corporation, for purposes of applying section 351(a). As a result, receipt of NQPS in a section 351 exchange is considered a taxable event. To constitute NQPS, stock must satisfy two conditions: (i) it must be preferred stock; and (ii) it must possess certain "debt like" features, such as mandatory put or call rights, or a dividend rate tied to interest rates, commodity prices, other similar indices. Thus, if stock is not considered preferred stock within the meaning of section 351(g), it by definition cannot constitute NQPS.

To constitute preferred stock within the meaning of section 351(g), stock must be limited and preferred as to dividends and, importantly, must "not participate in corporate growth to any significant extent." Prior to the enactment of section 351(g), courts had wrestled with this somewhat vague standard, and had taken different approaches for determining whether a particular instrument participates in corporate growth. Some courts looked only to the terms and rights of the instrument itself for purposes of making the relevant inquiry, an approach the IRS itself adopted at one point in time. Other courts went one step further and considered whether participating dividends were *actually* ever paid; if not, the mere legal right to receive such dividends was effectively disregarded for purposes of determining whether the instrument participated in corporate growth.

In an effort to resolve these differences, Congress deliberately included statutory language in section 351(g) providing that an instrument will not be treated as preferred stock if there is a "real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation." In this regard, the legislative history made clear that a bare legal right to participate in dividends or on liquidation, standing alone, is not sufficient to demonstrate participation in corporate growth. In *Gerdau MacSteel, Inc. v. Commissioner*, 139 T.C. 67 (2012), the Tax Court applied this more relaxed standard to conclude that an instrument which legally entitled its holders to certain participating rights nevertheless constituted preferred stock (which it ultimately held constituted NQPS) because the issuer had no earnings and was expected to continue incurring losses for the foreseeable future.

Relying on the case law, as well as the legislative history to section 351(g), the CCA concludes that the Class A stock was NQPS because, at the time the stock was issued to P, "there was no real and meaningful likelihood the Class A stock would participate in the corporate growth of Sub 1 to any significant extent." This conclusion was principally based on two key factors:

(1) No participating distributions were ever paid with respect to the Class A stock, and Sub 1's financial outlook did not suggest that this pattern was likely to change. In the year that the Class A shares were issued, Sub 1 had positive earnings yet paid no dividends. In the two years that followed, Sub 1 had net losses and did not pay dividends.

(2) Shareholder's demand for additional fees and collateral as a condition for its purchase of the Class A stock highlighted Sub 1's bleak future earnings expectations, as well as Shareholder's own concern about suffering a loss on the purchase.

Thus, the CCA confirms that, to avoid preferred stock treatment (and ultimately NQPS treatment), an instrument must carry a real and meaningful likelihood of participating in the corporate growth of the issuer. The CCA, however, leaves one important question unanswered: even if, at the time of issuance, there exists a meaningful likelihood that an instrument may participate in corporate growth, can an instrument nevertheless be treated as preferred stock if participating dividends are never paid with respect to the instrument? Concerned taxpayers may wish to affirmatively declare and distribute participating dividends to minimize the risk of challenge and recast.

By Michael Liu and Himali Patel (Summer Associate), Palo Alto

Be Careful What You Ask For: Refunds of Foreign Tax Paid Trigger FTC Redeterminations, Even if Such Refund May Later be Found to Have Been Erroneous

On May 1, 2017, the US Tax Court in *Sotiropoulos v. Commissioner*, T.C. Memo 2017-75, determined that a refund of foreign tax paid was a refund within the meaning of Code Section 905(c) in a situation where the foreign tax authority later disputed the taxpayer's right to the refund. In making this determination, the court explained that, "for US tax purposes, the term 'refund' does not connote finality or the final determination of a tax liability." Accordingly, while the court recognized that the taxpayer might ultimately be required to repay the refund, it found this to be irrelevant to whether or not the taxpayer received a refund that would require a foreign tax credit ("FTC") redetermination under section 905(c).

Background

The taxpayer, a US citizen resident in the United Kingdom, claimed FTCs on her timely filed US income tax returns for the amount of UK income tax withheld on her wages. The taxpayer also reported, on UK income tax returns, but not US income tax returns, her estimated share of deductions and losses generated by UK film partnerships in which she had invested. Once the taxpayer received final information from the film partnerships on her share of the deductions and losses, the taxpayer filed amended UK income tax returns. The taxpayer's original and amended UK income tax returns showed large overpayments of tax, attributable chiefly to the losses generated by the UK film partnerships, resulting in the taxpayer receiving a refund from the United Kingdom of substantially all of the UK income taxes that had been withheld from her wages (e.g., the tax for which she had claimed a FTC in the United States).

The taxpayer did not notify the IRS, by filing amended returns or otherwise, that the UK income taxes for which she had claimed FTCs had been refunded. The IRS, however, discovered, through information sharing with the United Kingdom, that the UK income tax for which the taxpayer had claimed a FTC in the United States had been refunded to her by the UK taxing authorities. Based on this, the IRS asserted that the taxpayer was not entitled to the FTCs she had claimed.

The taxpayer took the position that the returned amounts had not actually been "refunded" because the United Kingdom was disputing the taxpayer's entitlement to the film partnerships losses that had triggered the refund. The taxpayer also argued that she would be subject to double taxation if her originally claimed FTC was adjusted and she was only allowed to reclaim the FTC in the year the refunded tax was repaid, as her personal circumstances would likely not allow her the benefit of the FTC at the time repayment of the refund would likely be required.

Requirement to Report "Refunds" of Foreign Taxes Paid

Section 905(c)(1)(C) requires taxpayers, whether individuals or corporations, to notify the IRS when any tax paid is refunded in whole or in part. Upon receiving such a notification, the IRS redetermines the amount of tax for the affected years. If any tax is determined to be due as a result of such FTC redetermination, such

amount is required to be paid by the taxpayer upon notice and demand by the IRS.

Court's Analysis of the Meaning of the Term "Refund"

In evaluating the taxpayer's claim that the "refund" she received was not a "refund" for purposes of section 905(c)(1)(C), the court in *Sotiropoulos* applied standard principles of statutory interpretation, explaining that words used in a statute are given their ordinary meaning in the absence of persuasive reasons to the contrary. The court looked to the definition of "refund" in *Black's Law Dictionary* 1472 (10th ed. 2014), namely the "return of money to a person who overpaid, such as a taxpayer who overestimated tax liability or whose employer withheld too much tax from earnings." The court concluded that the amount returned to the taxpayer by the UK taxing authorities easily fell within the ordinary meaning of the word "refund."

The court also explained, citing *Goodyear Tire & Rubber Co. v. United States*, 14 Cl. Ct. 23 (1987), rev'd on other grounds and remanded, 856 F.2d 170 (Fed. Cir. 1988), rev'd and remanded, 493 U.S. 132 (1989), that whether or not a taxpayer who receives a refund under a claim of right will be entitled to actually keep such a refund is irrelevant to determining whether the amounts the taxpayer received from the UK taxing authorities were "refunds" for US tax purposes. The taxpayer in *Goodyear* argued that "refunded" in section 905(c)(1)(C) referred only to refunds of incorrect foreign taxes. The court in *Goodyear* rejected the taxpayer's argument, explaining that the reason for a refund is immaterial and that "the court would be hard-pressed to find any repayment of tax dollars to not be a refund as the term is used." *Goodyear*, 14 Cl. Ct. at 32. As further support for its decision, the court in *Sotiropoulos* pointed out that every year, the IRS generally issues refunds to the millions of Americans that file Forms 1040 showing an overpayment of tax. The court explained that these refunds are generally given automatically, with the understanding that the returns may be examined later and that the refund may later be required to be returned by the taxpayer. The mere fact that these amounts may later be required to be repaid did not, in the court's view, mean that the taxpayer did not initially receive a refund.

The court also rejected the taxpayer's second argument that adjusting her originally claimed FTC and only allowing her to reclaim the FTC in the year the refunded tax is repaid would result in double taxation. The court found that double taxation does not result simply because a taxpayer is not able to utilize all of the anticipated benefits associated with a FTC due to individual circumstances or the passage of time. Rather, such a result "simply reflects the facts that the future is unpredictable and that taxable income must be determined on an annual basis."

Key Points

Taxpayers claiming FTCs should be aware of the immediate consequences of any subsequent refunds of foreign taxes paid—a FTC redetermination under section 905(c)(1)(C). If there is a dispute over entitlement to the item potentially generating the FTC, it may be better to try and resolve that issue before obtaining receipt of the refund. In contrast, there may be situations where a taxpayer could actually benefit from a FTC being moved from the year originally claimed to a later year due to a refund and later repayment of such refunded amount.

The principles discussed in *Sotiropoulos* may also have relevance in situations where a taxpayer has paid a foreign tax, but is disputing whether such tax is actually owed. The reasoning used by the court in *Sotiropoulos* indicates the dispute over whether such amount is actually owed should not impact whether such a tax should be considered a foreign tax paid for purposes of computing the FTC, in the same way that the court refused to consider whether the refunded tax might have to be returned in deciding whether an amount refunded by a foreign taxing authority was a "refund" that would trigger a FTC redetermination under section 905(c)(1)(C).

The IRS's use of an information exchange agreement in *Sotiropoulos* also indicates that the IRS's use of such agreements may be expanding. As noted above, despite the taxpayer's failure to file amended returns upon her receipt of the refunded UK income tax, the IRS became aware of her refund due to an information exchange agreement with the United Kingdom. Information exchange agreements are regularly part of US income tax treaties, despite many recent tax treaties being blocked in the Senate due to concerns over the information exchange agreements. The IRS's use of information exchange agreements to obtain information can have broad implications for taxpayers with cross-border income, as it provides the IRS with a broader view of the taxpayer's global operations. With the implementation of OECD Action 13 country-by-country reporting, the IRS's use of such agreements to obtain information on US taxpayers is only likely to increase.

By Joy Williamson and Blake Martin (Summer Associate), Dallas

Wells Fargo Loses STARS Case, Penalty Imposed

On May 24, 2017, the US Federal District Court in Minnesota decided a tax refund action against Wells Fargo in a STARS case. *Wells Fargo & Co. v. U.S.*, 119 AFTR 2d 2017-1976 (D. Minn. 2017). The District Court's decision is another taxpayer loss on the structured foreign tax credit generator cases. *See* prior *Tax News and Developments* articles *First Circuit Rules Against Taxpayer on STARS Transactions* (Vol. XVII, Issue 2, March 2017), located under Insight at www.bakermckenzie.com and *Tax Court Holds that STARS Transaction Lacked Economic Substance* (Vol. XIII, Issue 2, April 2013).

The STARS Transaction

The STARS transaction was developed and marketed by Barclays Bank, PLC ("Barclays"), a UK-based bank, and KPMG. In simplified form, the STARS transaction operated as follows. The US taxpayer (or a related party) contributed income-producing assets to the STARS Trust (the "Trust"). The Trust then sold its shares to Barclays, and Barclays in turn loaned money to the US taxpayer through the Trust.

The STARS transaction was designed to satisfy all US and UK tax requirements. For UK tax purposes, Barclays was treated as the owner of the Trust and was, therefore, entitled to claim deductions and credits against its UK taxes. For US tax purposes, however, the US taxpayer was treated as the owner of the trust and, therefore, US taxpayer claimed foreign tax credits for the UK taxes paid by Barclays on the trust income. Barclay's investment was intended to be debt for US tax purposes and equity for UK tax purposes.

The Court's Opinion

The jury previously decided company did not have a non-tax business purpose or a possibility of a pretax profit for the trust investment and related foreign tax credits. The jury decided that foreign taxes were considered a "pre-tax" expense item in the test for economic substance. The court, in a footnote in its opinion, agreed with the jury's conclusion of the calculation of pre-tax profit. If the question of the treatment of foreign taxes is a legal conclusion and not a factual determination, the court agreed with the government's argument that foreign taxes are a "pre-tax" expense. The jury separately decided that the loan to Wells Fargo had economic substance, and the court allowed the interest deduction.

The Penalty Issue

The IRS had asserted the negligence penalty under Code Section 6662 to the transaction. The court framed the penalty issue as follows: "In order to limit discovery, Wells Fargo stipulated that it would assert only two defenses to the government's negligence-penalty claim: (1) that STARS was not a sham and therefore Wells Fargo is not liable at all, and (2) that, even if STARS was a sham, there was an objectively reasonable basis for Wells Fargo's return position under the authorities referenced in [Treas. Reg.] § 1.6662-3(b)(3)." The court then adopted the IRS argument that the reasonable basis defense to the negligence penalty required actual reasonable reliance on the authorities at the time of the filing of the tax return. Objective reasonableness of the tax return position was not a defense under the court's reading of the Treasury Regulations.

The Appeal?

The Eighth Circuit appeal could be interesting for Wells Fargo. Obviously, the legal determination that an objectively reasonable position without proof of actual reasonable reliance on the authorities is an issue ripe for appeal. In addition, the determination of "pre-tax" profit being a factual issue or a legal issue, and the determination that "pre-tax" profit for purposes of the economic substance test is a post-foreign tax, pre-US foreign tax credit calculation, both present issues for the Eighth Circuit. The Eighth Circuit in the IES case previously held for the taxpayer that pre-tax profit for purposes of the economic substance test was (1) a legal determination and (2) pre-tax meant before all taxes, US and foreign, *IES Industries, Inc. v. Commissioner*, 253 F.3d 350 (8th Cir. 2001); see also *Compaq Computer Corporation v. Commissioner*, 277 F.3d 778 (5th Cir. 2001). The Eighth Circuit in *IES* and the Fifth Circuit in *Compaq* held that for purposes of the calculation of pre-tax profit, foreign taxes were taxes and not expenses of the transaction. Wells Fargo had argued on summary judgment that *IES* had previously determined the calculation of pre-tax profit as a matter of law, but the court rejected the argument and allowed the issue to be tried as a factual issue to the jury. An appeal to the Eighth Circuit could create a split between the Circuit Courts of Appeal on the STARS cases.

By Robert S. Walton, Chicago

Proposed Partnership Audit Regulations Showcase Major Changes Starting in 2018

On June 14, 2017, the IRS issued proposed regulations, REG 136118-15, (the "Proposed Regulations") similar to the "almost proposed" regulations that were

suspended as part of a broader Executive Order regulatory review. The Proposed Regulations implement the transformative rules of the entity-level partnership audit regime enacted as part of the Bipartisan Budget Act of 2015, P.L. 114-74, as amended by the Protecting Americans from Tax Hikes Act of 2015, P.L. 114-113, (the “BBA” rules). The BBA rules completely replace the long-standing audit rules that were enacted by the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, (“TEFRA”). The primary differences between the BBA rules and the TEFRA rules are: (1) the IRS assesses the tax at the partnership level absent taxpayer action to “push out” the adjustment to the partners; (2) the tax is imposed at the highest marginal rate absent the partnership proving that the partners would have been taxed at a lower rate; (3) the BBA rules give absolute audit control to the “Partnership Representative” (former Tax Matters Partner concept), and the IRS no longer notifies the partners of the audit; (4) the Proposed Regulations greatly expand the scope of issues decided in the partnership-level audit; and (5) the IRS now assesses the partnership for traditionally partner-level tax obligations such as assessments for tax on contributed built-in gain property and disguised sales. The BBA rules apply to both foreign and domestic partnerships for taxable years starting January 1, 2018 absent an unlikely taxpayer election for earlier implementation.

As a practical matter, it is important for partnership agreements to address the real world complications of the BBA rules including addressing: (1) contractual limitations on the Partnership Representative’s otherwise absolute authority; (2) keeping partners reasonably informed and involved in the audit process; (3) partnership rights to potentially elect out of the new regime or push out adjustments to partners; (4) partnership rights to call funds from partners to pay partnership-level assessments; and (5) partnership rights for partner cooperation to obtain necessary information to calculate tax at the partnership level or to push out adjustments to the partners.

I. Overview of the BBA and TEFRA

The BBA rules replace the rules that were in effect under TEFRA, which will be abolished beginning January 1, 2018. The new regime is intended to simplify the administration of partnership audits. Under TEFRA, adjustments to "partnership items" are made at the partnership level. Once the treatment of a partnership item is determined, corresponding adjustments are made to each partner’s return, with the assessment ultimately being made against individual partners. In addition, the IRS is required to follow normal deficiency procedures to make partner-level adjustments to “affected items”—i.e., any item that is affected by a partnership item, and other items.

The BBA rules centralize partnership audit proceedings by treating the partnership as the taxpayer and determining all partnership adjustments (and assessing and collecting any tax attributable thereto) at the partnership level. The applicability of any penalty or addition to tax is also determined at the partnership level. Unlike under prior law, the new regime does not distinguish between “partnership items” and “affected items.” Instead, the BBA applies to all “items of income, gain, loss, deduction or credit of a partnership” for a partnership taxable year and any partner’s distributive share thereof. Significantly, the BBA statutory provisions address only items running through the partnership and do not directly address how items that would be considered “affected items” under TEFRA should be addressed. However, the Regulations have attempted to address this indirectly by broadly defining “partnership items” to include many of the concepts

that were previously “affected items”—thus bringing more items into the scope of partnership-level audit adjustments.

Under the BBA rules, because adjustments are made at the partnership level, imputed underpayments could result in overstatements of tax. To correct for potential overstatements, the centralized partnership audit regime includes modification procedures, but imposes the burden on the partnership to make the adjustments necessary to determine the correct amount of tax. Partnerships can modify imputed underpayments by submitting certain information to the IRS within 270 days of the date the notice of proposed partnership adjustment is mailed.

II. The New Proposed Regulations under the BBA

The Proposed Regulations broadly apply the BBA and provide that the centralized partnership audit regime applies to partnership-related items, including the character, timing, source, and amount of items; the character, timing and source of the partnership’s activities; contributions to and distributions from the partnership; the partnership’s basis in its assets and the value of those assets; the amount and character of partnership liabilities; the separate category, timing, and amount of the partnership’s creditable foreign tax expenditures; elections made by the partnership; items related to transactions between a partnership and any partner (including disguised sales and guaranteed payments); any items related to terminations of a partnership; and partners’ capital accounts. Compare this phrase to Code Section 6221 under the TEFRA rules, which refers only to items of “income, gain, loss, deduction or credit of partnership”. Important aspects of the Proposed Regulations include procedures for electing out of the centralized partnership audit regime, procedures for filing administrative adjustment requests, and procedures for determining amounts owed by the partnership or its partners attributable to adjustments. The Proposed Regulations also provide rules for the “Partnership Representative.”

A. Push Outs

Under the BBA, a partnership may elect to “push out” adjustments to its reviewed-year partners— i.e., partners that were partners in the partnership during the year for which additional tax is assessed. If the election is made, the imputed underpayment must be paid by the reviewed year partners. The election must be made no later than 45 days after the date of the notice of final partnership adjustment.

Whether tiered partnerships can push out adjustments beyond the first tier has been a subject of debate since the BBA was enacted as doing so would create administrative challenges. The preamble to the Proposed Regulations explains that allowing multiple tiers to push out adjustments could produce complexities and inefficiencies similar to those experienced under TEFRA. While the almost proposed regulations, as published in January, raised these concerns, the Proposed Regulations expand upon Treasury’s and the IRS’s concerns. Nonetheless, the Proposed Regulations ultimately reserve on the issue. Treasury and the IRS are considering an approach that would allow adjustments to be pushed out beyond first-tier partners. This will be the subject of future proposed regulations. Treasury and the IRS are seeking comments on how the IRS might administer tiered structures, including comments on information tracking to

ensure that adjustments are properly flowed through tiers and on how to reduce noncompliance and collection risk in tiered structures.

B. The Partnership Representative

The Proposed Regulations discuss the role of a Partnership Representative, which replaces the role of the tax matters partner that represents the partnership in proceedings under TEFRA. Unlike the tax matters partner, the Partnership Representative need not be a partner in the partnership but must have a "substantial presence" within the United States. The partnership is required to designate the Partnership Representative each year on its tax return for the year. The Partnership Representative has broad authority to bind the partnership, and any action taken by the Partnership Representative is binding on the partnership and its partners. Thus, unlike under TEFRA, partners will not be able to participate in or contest results of an IRS examination of the partnership. Only the Partnership Representative is entitled to raise defenses to penalties, additions to tax, or additional amounts, including defenses available to the partnership or any partner. The Partnership Representative's failure to raise a defense before a final determination is made would be considered waiver of that defense. Critically, in contrast to notification obligations that TEFRA imposed on the tax matters partner, the Partnership Representative is not required to notify partners of an audit or related proceedings. Given the scope of the Partnership Representative's authority under the BBA, the partnership agreement should consider imposing a contractual obligation on the Partnership Representative to notify partners of materials events. Partnerships should also consider using the partnership agreement to limit the scope of the Partnership Representative's authority.

C. Election Out for Small Partnerships

Qualifying small partnerships may elect out of the centralized audit partnership regime. A small partnership is broadly defined as a partnership with 100 or fewer partners in which all partners are "eligible partners." Eligible partners include individuals, C corporations, S corporations, a deceased partner's estate, or foreign entities that would be treated as C corporations if they were domestic. Notably, partnerships and disregarded entities are excluded from this definition. While the statute grants Treasury the authority to expand this definition, the Proposed Regulations do not expand the definitions provided by the statute. To elect out of the centralized partnership audit regime, a qualifying small partnership must file an election each year. The election is valid only for that year. If a qualifying small partnership elects out of the regime, the partnership and partners would be audited under the general rules applicable to individual taxpayers.

The preamble to the Proposed Regulations warns of the potential for abuse of the election and states that the IRS intends to carefully review elections. Its review will include an analysis of whether the partnership has correctly identified all of its partners and an evaluation of whether two or more partnerships that have elected out should be recast under existing judicial doctrines and general federal tax principles as having formed one or more constructive or de facto partnerships for US federal income tax purposes.

In addition to clarifying concerns regarding push outs for tiered partnerships, the Proposed Regulations depart from the almost proposed regulations that were

published in January by deleting an example relating to the netting or ordinary income and depreciation (i.e., the January version of Prop. Reg. Section 301.6225-1(f) Ex. 3).

D. Looking Forward

Requests for Comments: Comments to the Proposed Regulations are requested by August 14, 2017.

Technical Corrections Legislation: House members proposed technical corrections legislation in December 2016 that would have clarified aspects of the BBA. The proposed legislation provided that partnership and S corporation partners could push out an underpayment to the partner-entity's partners. This would enable an imputed underpayment to be pushed out beyond the first-tier partners to ultimate partners or investors in the partnership. The proposed legislation also expanded the scope of "partnership adjustment" to include "any adjustment to a partnership-related item," defined to include "any item or amount with respect to the partnership." The proposed legislation has not moved forward this year, and it is unclear if or when Congress will advance any technical corrections legislation to the BBA.

By Lindsey Goble, New York and Steve Schneider, Washington, DC

A Real Pain in My "Cap A"

If you have been following the recent developments involving Code Section 1234A, which includes the IRS's reversal of its position on the treatment of merger termination fees, you may not be surprised to hear that another wrinkle has been added to the ever-changing interpretation of section 1234A with the Tax Court's recent ruling in *Hurford Investments No. 2, Ltd. v. Commissioner*, Dkt No. 23017-11 (T.C. Apr. 17, 2017).

Section 1234A provides that any gain or loss attributable to the cancellation, lapse or termination of "a right or obligation . . . with respect to property which is (or would be) a capital asset in the hands of the taxpayer" should be treated as gain or loss from the sale of a capital asset. The provision was originally intended to apply, and has traditionally been applied, where taxpayers were provided an election to treat a gain or a loss as capital or ordinary. As an example, a taxpayer would enter into forward currency contracts whereby the taxpayer would purchase a foreign currency from a third party for future delivery and also sell the same foreign currency for future delivery. If the currency went up in value, the taxpayer would sell his contract to receive the foreign currency to another party, recognizing a capital gain. In addition, the taxpayer would cancel the contract to deliver the foreign currency and pay the losses to the third party rather than actually delivering the foreign currency. The taxpayer would treat the payment as an ordinary loss, rather than a capital loss. *See* S. Rep. No. 97-144 (July 6, 1981). Thus, the taxpayer achieved the best of both worlds, an ordinary loss and a capital gain. Section 1234A puts a stop to that treatment by causing the termination of the obligation to deliver the foreign currency as a capital loss, thereby stopping the taxpayer's ability to elect treatment.

In *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), the Court of Appeals held that the termination of rights in a capital asset itself does not fall within section 1234A. The taxpayer owned stock that had substantially

decreased in value. The corporation offered to redeem the stock for pennies on the dollar. The taxpayer determined that it was more beneficial to abandon the stock and utilize the loss to offset ordinary income. At trial, the judge asked to be briefed on the application of section 1234A to the abandonment of the stock—i.e., whether section 1234A applied to treat the loss as a capital loss. The Tax Court held that section 1234A applied to such abandonment, because the taxpayer terminated its inherent property rights in the stock, a capital asset. The Court of Appeals reversed this decision and held that section 1234A does not apply to the termination of rights inherent in the property that is the capital asset.

Now, we come to the Tax Court's recent ruling in *Hurford Investments*. In *Hurford Investments*, the Tax Court held that the payments received on the termination of a phantom-stock plan from the employer of a decedent were long term capital gain under section 1234A. The phantom stock was a form of deferred compensation that a company, Hunt Oil, gave to its employees, which allowed them to share in the company's growth without actually issuing stock to such employees. The phantom stock was valued at approximately the price of a share of Hunt Oil common stock. The phantom stock was a contractual right to receive payment based on the value of such stock as well as any dividends, and could be transferred by its holder. In *Hurford Investments*, the employee had passed away in 1999 and this provided for a five-year countdown by which the company would redeem the phantom stock. The employee's wife inherited the phantom stock and transferred it into a partnership as part of her estate planning. The wife passed away in 2001 and the stock was subsequently redeemed in 2004. An interest-bearing account was established, which could still fluctuate based on the value of the stock of the company and was payable on demand by either party. In 2006, the company terminated the account and paid out the value to the partnership. The question involved in the order was whether the payment received by the partnership should be long term capital gain or ordinary income.

The Tax Court held that section 1234A applied to the payment in redeeming the phantom stock. The Tax Court seems to utilize a *Pilgrim's Pride*-type application that was overturned by the Fifth Circuit on appeal. As mentioned above, the Tax Court in *Pilgrim's Pride* held that section 1234A applied to the termination of inherent property rights in the capital asset referred to in section 1234A. The Tax Court's reasoning in *Hurford* I*nvestments* is similar and is as follows: "[b]oth parties to the phantom-stock arrangement had the right to liquidate the account at any time. When Hunt Oil liquidated the phantom stock and distributed the proceeds, it ended [the partnership's] right to sell the phantom stock when it chose. We think that means there was a termination of a right to buy or sell a capital asset, and not an abandonment of property, under [*Pilgrim's Pride*]. [The partnership] still owned the rights to the phantom stock or, after the liquidation, to the cash proceeds. We therefore conclude that the transaction was a sale or exchange of a right to sell a capital asset under section 1234A(1) and [the partnership] is entitled to capital gains treatment."

Why does this case matter? Although the taxpayer in *Hurford Investments* was able to achieve a favorable result from the ruling, this case presents issues in extrapolating the Tax Court's reasoning to the payor. If a contract can be assigned by one party ("Party A") and Party A terminates its contract with the other party ("Party B") and pays a fee, does Party A have to recognize a capital loss rather than taking an ordinary deduction for its payment to Party B? Party A had the right to sell the contract when it chose and it could be a capital asset in the hands of the taxpayer. Party A terminated such right and, based on the Tax Court's reasoning in *Hurford Investments*, Party A may have to recognize a

capital loss. Thus, this case adds to the confusion as to how a payment should be treated when made for the termination of a contractual right or obligation. This is especially true in the context of payments made in termination of merger agreements, where payments can be quite large. This confusion will unfortunately lead to more litigation until the courts finally come to a consensus on what it means to terminate "a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer." Section 1234A(1).

As the Fifth Circuit Court of Appeals had determined, the termination of inherent property rights in the capital asset itself should not be considered a right "with respect to property which is . . . a capital asset." The Tax Court in *Hurford Investments* could have identified the Hunt Oil stock as the "with respect to property which is . . . a capital asset." However, that is a loose correlation, as section 1234A should be read to refer only to contractual arrangements to either purchase or sell a capital asset, which the Tax Court in *Hurford Investments* understood. This likely led to the Tax Court's reasoning to be based on the termination of the right to sell the contractual right (i.e., the phantom stock). *See Hurford Investments,* Dkt. No. 23017-11, at 11 (stating that "[t]he Fifth Circuit [in *Pilgrim's Pride*] tells us that if there's no sale or exchange and *there's no termination of a right or obligation to buy or sell*, then there can't be capital-gains treatment") (emphasis added). *Pilgrim's Pride* dealt with how close "with respect to" meant for the termination of a right (i.e., the rights inherent in the property itself did not fall within the statute). The fact pattern of *Hurford Investments* is a good indication of where the next cases will likely be for section 1234A. How far can "with respect to property" be stretched before snapping?

By Marc Casale, New York

Canada Signs Multilateral Instrument

Canada signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "MLI") on June 7, 2017. To date, 68 other countries have signed (including the UK, Luxembourg, Ireland and the Netherlands), and eight others have expressed their intention to sign.

The MLI arose from the Organisation for Economic Co-operation and Development (the "OECD") and the G20's base erosion and profit shifting ("BEPS") project. The MLI seeks to modify the existing bilateral tax treaties of signatories in a streamlined manner in order to implement treaty-related BEPS measures without the need to individually renegotiate each treaty.

The MLI only applies to a bilateral tax treaty if both treaty partners have ratified the MLI and listed the treaty as a covered tax agreement. Canada has provided the OECD with a provisional list of 75 treaties to which it would like the MLI to extend. Notably excluded are the US, Germany and Switzerland; the US is not a signatory to the MLI, and Canada has announced its intention to enter into bilateral negotiations with Germany and Switzerland.

The MLI contemplates that signatories may register reservations (i.e., opt out) in respect of provisions other than the minimum standards. Many provisions (including the minimum standards) also provide signatories with choices. The provisions contain compatibility clauses to determine the consequences where

there is a "mismatch" between the options chosen by the parties to a covered tax agreement (generally, non-application to the extent of the inconsistency).

A country can withdraw or limit a reservation, but cannot add or broaden a reservation. Canada has reserved in respect of all MLI provisions other than the minimum standards and mandatory binding arbitration, but has stated that it will continue to assess whether to adopt other provisions (including, e.g., the permanent establishment and hybrid mismatch provisions) at the time the MLI is ratified.

The minimum standards include treaty shopping rules and a comprehensive mutual agreement procedure. The treaty shopping rules consist of a preamble and a substantive technical rule. The preamble provides that the purpose of the covered tax agreement is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. With respect to the substantive technical rule, signatories may choose a principal purpose test, limitation on benefits provision, or a combination of both. Canada has chosen the principal purpose test, but has stated its intention to seek to negotiate, on a bilateral basis, limitation on benefits provisions where appropriate (either in addition to, or in replacement of, the principal purpose test). The principal purpose test denies all or part of the benefits of a treaty where one of the principal purposes of an arrangement or transaction was to obtain those benefits.

The mandatory binding arbitration provision chosen by Canada is a "final offer" model similar to that already contained in the Canada-US tax treaty and is intended to ensure disputes are resolved within a specific timeframe. That is, where the competent authorities are unable to reach an agreement under the mutual agreement procedure, the dispute is referred to binding arbitration, at which point the arbitration panel will choose between the competent authorities' proposed resolutions by a simple majority.

The Department of Finance has estimated that the MLI could enter into force as early as December 1, 2018, in which case it could come into effect for withholding tax purposes on January 1, 2019 and for income tax purposes for tax years beginning on or after June 1, 2019.

By Stephanie Dewey, Toronto

UK High Court Rejects Privilege Claims Relating to Internal Investigation: Implications for US and Canadian Taxpayers

"Is this document privileged in France and Italy?" "What protections do we have for this communication in the United Kingdom and Germany?" "If it's privileged in the US, how is it that foreign tax auditors are asking for it?" These questions are increasingly common for taxpayers facing more coordinated and aggressive tax authorities around the globe. Taxpayers are well-advised to assume that information collected by one tax authority will be shared among all tax authorities. As well, the need to maintain confidentiality of sensitive information must now take into account the applicable legal protections in each jurisdiction where a taxpayer has a presence. This is why the recent UK judgment in *Serious Fraud Office v. Eurasian Natural Resources Corporation Ltd.*, [2017] EWHC 1017 (QB), warrants close attention, especially because the English Court ruled that privilege

did not apply to documents created during an internal investigation (which may be surprising to many US and Canadian taxpayers).

Facts

In late 2010, Eurasian Natural Resources Corporation Ltd ("ENRC") received an email from a whistleblower alleging corruption by ENRC's subsidiary in Kazakhstan. ENRC launched an internal investigation led by its outside counsel. In August 2011, the UK Serious Fraud Office ("SFO") contacted ENRC to highlight the SFO's anti-corruption self-reporting guidelines in response to a media leak relating to the 2010 whistleblower email. The ensuing dialogue between ENRC and the SFO was made in the context of the UK self-reporting regime. However, in 2013, ENRC terminated its outside counsel responsible for the internal investigation (which counsel had also been representing it before the SFO), and the SFO then commenced a criminal investigation into ENRC's affairs. As part of that criminal investigation, the SFO sought to compel the production of documents created by lawyers and forensic accountants engaged to assist ENRC in its internal investigation. These documents included lawyers' notes from interviews with current and former employees and third parties, which ENRC claimed were subject to litigation privilege and/or legal advice privilege.

The High Court's Ruling

UK litigation privilege (similar to Canadian litigation privilege and the US work product doctrine) applies to communications made between parties, or their solicitors and third parties, for the sole or dominant purpose of conducting existing or contemplated adversarial litigation. The High Court ruled that litigation privilege did not apply to the documents at issue because ENRC could not demonstrate that adversarial litigation was contemplated when the documents were produced (even if a criminal investigation was reasonably contemplated at that time). In particular, the High Court held that ENRC had identified no evidence at that time suggesting that there was any truth to the allegations. Unlike civil suits, the Court underscored that criminal prosecutions cannot be reasonably contemplated unless the client knows enough to realistically expect that a prosecutor will be satisfied that there is sufficient evidence "to stand a good chance of securing a conviction." The High Court also held that, even if it were mistaken and ENRC reasonably contemplated adversarial litigation (*e.g.*, prosecution) when the documents were created, "the documents for which litigation privilege is claimed were not created with the dominant purpose of being used in the conduct of such litigation." Rather, the dominant purpose in creating those documents was to determine whether the whistleblower's allegations had any merit (or, in the case of certain accounting documents: to meet compliance requirements).

UK legal advice privilege (similar to US attorney-client privilege and Canadian solicitor-client privilege) applies to all communications made in confidence between clients and their lawyers for the purpose of giving or obtaining legal advice, even when litigation is not contemplated. The High Court ruled that the lawyers' notes from interviews with current and former employees and third parties were not subject to legal advice privilege where those notes were not prepared in the course of conveying instructions to the lawyers by persons authorized to instruct them on the client's behalf. In that regard, communications with ENRC's employees or former employees was considered to fall beyond the relevant privilege continuum except where those employees were effectively tasked by ENRC to seek or obtain legal advice. Further, the lawyers' notes were held not to be protected legal work product when the evidence showed that they

merely recorded what the lawyers were told by the witnesses -- effectively reflecting a bare fact-gathering process rather than one aimed at giving or providing legal advice. However, where certain documents reflected that counsel had been instructed to give legal advice about specific matters consequential on their prior fact-finding, those documents were covered by legal advice privilege.

Implications for US Taxpayers

Because ENRC may yet appeal the High Court's ruling, the full impact of the *SFO v. ENRC* judgment may have to wait for the Court of Appeal's review. Nevertheless, the ruling offers several important lessons for taxpayers operating on a global basis. For US-based multinationals, the prospect that outside counsel's interview notes and communications may not be privileged is a daunting one. The High Court's ruling draws a sharp contrast with US privilege law, explicitly rejecting the US Supreme Court rule from *Upjohn Co. v. United States*, 449 U.S. 383 (1991), that attorneys' communications with employees that are necessary for a lawyer to provide legal advice to the company may be protected under the attorney-client privilege. Under ENRC, only communications between a lawyer and those employees authorized to obtain legal advice on the company's behalf -- a much smaller subset of employees -- are protected by the legal advice privilege. Because extensive employee interviews are often required to assess a taxpayer's exposure relating to transfer pricing or permanent establishment issues, for example, the High Court's ruling should urge caution in how attorneys memorialize employee interviews in tax matters affecting the United Kingdom and, potentially, other non-US jurisdictions. In light of *SFO v. ENRC*, taxpayers and their counsel should prepare such interview memoranda expecting that they will be provided to the government.

The High Court's ruling on UK litigation privilege also highlights potential traps for US taxpayers accustomed to the US work product doctrine. The High Court's ruling was made in the context of potential criminal prosecution. ENRC's claim that it anticipated litigation in the face of a likely investigation into alleged corruption was insufficient to trigger UK litigation privilege because the company had not discovered facts suggesting that a prosecution would be warranted. Critical to the High Court's ruling was the fact that criminal prosecutions require a prosecutor to have a sufficient evidentiary basis, and the company, at the time the disputed documents were created, could not prove that it knew of facts suggesting that such an evidentiary basis existed. The High Court's ruling therefore suggests a sliding scale -- not applicable under US law -- between criminal and civil tax issues to determine when contemplation of litigation is sufficient to trigger the litigation privilege, with companies anticipating criminal litigation required to have a greater evidentiary basis for the litigation privilege to apply.

Even in purely civil matters, the UK's "sole or dominant purpose" requirement creates a seemingly higher standard than the "because of" standard required for US work product protection to apply. (For US courts applying the "because of" standard for work product protection, documents are deemed prepared because of litigation if "in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation." *Richey v. United States*, 632 F.3d 559 (9th Cir. 2011) (internal quotation marks and citations omitted)). Simply put, documents created for litigation and non-litigation purposes routinely receive work product protection in the United States; such documents in the United Kingdom will only be protected by litigation privilege if the taxpayer can establish

that the litigation purpose was dominant. As a result, memorializing the purpose for which a document is created, and the basis for any anticipated litigation, may be increasingly important in the United Kingdom and, potentially, other non-US jurisdictions.

Implications for Canadian Taxpayers

Such considerations and takeaways also apply to Canadian taxpayers. While precise differences in concept and application may exist when comparing English litigation privilege to corresponding Canadian principles, Canadian litigation privilege does generally depend on the similar question of whether records were created for the dominant purpose of actual or reasonably anticipated litigation. Even so, the general overlap of potential civil and criminal liability in the Canadian tax context suggests there may be significant practical limits to applying *SFO v. ENRC*'s litigation privilege principles in Canada. Other important differences become apparent when comparing Canadian solicitor-client privilege and UK legal advice privilege.

Like in the UK, solicitor-client privilege in Canada recognizes the continuum of communications within which confidential information is shared for the purpose of rendering legal advice. Canadian jurisprudence, however, appears to recognize a more-fulsome conception of that continuum than that described in *SFO v. ENRC*. For example, while the confidential communication must be connected to obtaining legal advice, it is clear that legal advice is not confined to merely telling the client the state of the law; it also includes ascertaining or investigating the facts upon which the advice will be rendered. Thus, where counsel conducts a factual investigation and analysis for the purpose of giving legal advice to a client, privilege should generally attach to counsel's work product. As well, there are other important exceptions that extend solicitor-client privilege to cover certain types of communications with third parties. For example, it is an established principle that Canadian solicitor-client privilege protects communications with a third party not only where the third party acts as agent for the client, but also where the third party performs a function essential to the solicitor-client relationship (such as employing its expertise in assembling information provided by the client and translating or explaining it to the lawyer).

At bottom, key determinations to be made in a Canadian privilege dispute are usually questions of fact, and the same general advice applies to Canadian (as well as US) taxpayers even against the backdrop of legal developments such as those in *SFO v. ENRC*. That is, taxpayers will be well served by considering issues of privilege before commencing a new internal or external investigation, properly memorializing their internal and external engagements, and ensuring that best practices (both local and foreign) are in place for obtaining and documenting all sensitive information.

By Mark Roche, San Francisco and Mark Tonkovich, Toronto

Taxpayers Should be Aware of Special FICA Refund Procedures Before Filing Refund Claims

Taxpayers who find themselves having overpaid Federal Insurance Contribution Act ("FICA") taxes should be sure to familiarize themselves with the special procedural rules that apply to FICA refund claims before filing any such claims. These special rules stem from the fact that an employer pays half of the FICA taxes directly and withholds the other half from the employee. Taxpayers should

make sure to understand their obligation to make a claim on behalf of the employee for the taxes withheld from the employee when seeking a refund of the FICA taxes the employer paid directly. Failure to protect the employee's claim for his or her share of the FICA taxes can put a company's refund of the employer's share of the FICA taxes at risk. The special procedural rules that apply, including the potential impact of the IRS' recent guidance in Rev. Proc. 2017-28, are addressed in an article by Anne Batter published in the July/August 2017 issue of Corporate Taxation, *IRS Clarifies Employee Consent Requirements in FICA Refund Cases*.

For the complete article, *See IRS Clarifies Employee Consent Requirements in FICA Refund Cases,* (Batter, Anne, *Corporate Taxation, July/August 2017*).

Kokesh v. SEC: Are Disgorgement Payments Still Deductible Under Code Section 162?

On June 5, 2017, a unanimous United States Supreme Court issued its eagerly anticipated opinion in *Kokesh v. SEC*, No. 16-529 (U.S. June 5, 2017). While the opinion involves the applicability of a five-year statute of limitations to SEC disgorgement actions, the holding may also have significant implications for taxpayers. Specifically, the Court's holding has placed in doubt the deductibility of disgorgement payments under section 162. For a more thorough analysis of the *Kokesh* opinion and its impact on taxpayers, please see the Baker McKenzie Client Alert "*Kokesh v. SEC*: Are Disgorgement Payments Still Deductible Under Code Section 162?", distributed on June 22, 2017.

Spousal Portability of Estate Tax Exclusion - Revenue Procedure 2017-34

The portability election allows a surviving spouse to utilize their deceased spouse's unused exclusion amount. The exclusion is the most an individual can transfer during their lifetime or at death without incurring gift or estate tax. The current exclusion amount (which is adjusted annually for inflation) is US$ 5,490,000. Any exclusion remaining at the deceased spouse's death is available for the portability election. In the event the executor of the deceased spouse fails to file an estate tax return within the required time, the ability for the surviving spouse to use the deceased spouse's unused exclusion amount is lost unless relief is granted.

In February 2014, the IRS issued Revenue Procedure 2014-18 which provided a simplified method for obtaining an extension of time to make a portability election. This simplified method was only available until December 31, 2014. According to the IRS, since this time it has been placed under a significant burden by taxpayers who have requested numerous letter rulings to obtain an extension of time to make a portability election. Therefore, the IRS determined that there was a need to implement another round of guidance to allow for a simplified method of obtaining an extension of time to make a portability election. Revenue Procedure 2017-34 provides this new simplified method. It is available to executors who file on or before the later of January 2, 2018, or the second anniversary of the decedent's death. Please see previously released global wealth management client alert, *The IRS Implements a Simplified Method for Obtaining an Extension of Time to Make a Portability Election, Again,* distributed on June 16, 2017.

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Colorado District Court Holds Economic Nexus Exists for a Minnesota Intangible Holding Company and Agrees to a Modified Alternative Apportionment Method

A Colorado district court held that Target Brands, Inc. ("TBI"), a subsidiary intangible holding company of Target Corporation ("Target"), had economic nexus with Colorado, but that the Department of Revenue (the "Department") failed to use a reasonable alternative apportionment method when it assessed nearly $20 million in state corporate income tax for tax years 1999 through 2009. The case, *Target Brands Inc. v. Department of Revenue*, 2015CV33831, decided by the District Court of the City and County of Denver on January 27, 2017, highlights yet another example of aggressive economic nexus and alterative apportionment arguments of state revenue agencies to expand their revenue base by capturing income from out-of-state intangible holding companies.

TBI first argued that it did not have nexus with Colorado because it had no physical presence in the State, and thus could not be subject to the State's corporate income tax. The court did not agree and instead found economic nexus to exist because: i) TBI chose to license its IP for use by Target in Colorado; ii) directed use of its IP by Target within the State; and iii) received millions of dollars in income related to Target's use of TBI's IP within the State. The court then found the Department had properly invoked its alternative apportionment authority by proving, by a preponderance of the evidence, that the default apportionment formula—generally consisting of a property factor, a payroll factor, and a sales factor--did not fairly reflect TBI's business activity in Colorado. However, the Court also found that the Department's alternative apportionment formula, consisting of a single sales factor based on TBI's parent's (i.e., Target's) sales not to be reasonable. Instead, the Department was instructed to include TBI's payroll and property factors in addition to Target's sales factor for purposes of determining TBI's Colorado apportioned income.

For more discussion and insight on the Target Brands case, please see the SALT Savvy blog post from June 20, 2017, *Colorado District Court Holds Economic Nexus Exists for a Minnesota Intangible Holding Company and Agrees to a Modified Alternative Apportionment Method*, available at www.saltsavvy.com.

The New California – Tax Administration and Appeals Agencies Revamped

Major reform is coming to the way California administers its tax laws. On June 27, 2017, the Taxpayer Transparency and Fairness Act of 2017 (A.B. 102 or the "Act"), was signed into law by Governor Jerry Brown after passing both the California Senate and Assembly with little resistance. The Act fundamentally alters the administration of California's tax laws by divesting the California State Board of Equalization ("Board") of several of its key functions and assigning them to two new government agencies established by the Act: (1) the California Department of Tax and Fee Administration ("Tax Department"); and (2) the Office of Tax Appeals.

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Under the new law, the Board will continue to retain the duties and powers granted to it under the California Constitution relating to certain property tax oversight and assessment functions, insurance company taxes, and alcoholic beverage taxes, as well as its statutory duty to adjust motor vehicle fuel tax rates for the 2018-2019 fiscal year. The Board's duties and powers will otherwise be limited. The Office of Tax Appeals will now take over the tax appeals function currently performed by the Board, and the Tax Department will take over all remaining duties and powers currently held by the Board (i.e., the administration of sales/use taxes and special taxes and fees).

For more discussion and insight on the Taxpayer Transparency and Fairness Act of 2017, please see the SALT Savvy blog post from June 28, 2017, *The New California – Tax Administration and Appeals Agencies Revamped*, available at www.saltsavvy.com.

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