Tax News and Developments

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In This Issue:

Tax Reform: Where We Stand

Congress has made substantial progress on tax reform over the past few weeks, yet several hurdles remain before any legislation becomes final. Building on the Unified Framework deal struck by the Big Six (*see prior Tax News and Developments* article *Time for Tax Reform?* (Vol. XVII, Issue 9, Oct. 2017) located under Insight at www.bakermckenzie.com/tax), the House Ways & Means (W&M) Committee released its Tax Cuts and Jobs Act on November 2nd, and W&M Chairman Rep. Kevin Brady released his amendment in the form of a substitute ("Chairman's Mark") on November 3rd (*see Tax Cuts and Jobs Act,* and *Chairman's Mark*). For further analysis of the Chairman's mark, please see prior *Tax News and Developments* Client Alert, "*Ways and Means Committee Releases "Tax Cuts and Jobs Act*", distributed on November 3, 2017. The Committee's four-day markup started on November 6th, during which several minority amendments were introduced and voted down, and two manager's amendments were approved on November 6th and November 9th (*see Amendment to the Amendment in the Nature of a Substitute to H.R. 1* and *Amendment to the Amendment in the Nature of a Substitute to H.R. 1 Offered by Mr. Brady of Texas*). The bill was passed out of the Committee on November 9th, and was passed by the full House on November 16th (*see H.R. 1*). The final vote in the full House was 227-205 (all Democrats voted against the bill, joined by 13 Republicans).

With respect to the Senate, on November 9th, the Joint Committee on Taxation released its Description of the Chairman's Mark of the Tax Cuts and Jobs Act (*see Description of the Chairman's Mark of the "Tax Cuts and Jobs Act*"). For further analysis of the Senate proposal, see prior *Tax News and Developments* Client Alert, "*Senate Finance Committee Releases "Chairman's Mark" of Tax Reform Legislation; Mark Up Begins*", distributed on November 13, 2017. As is normal practice, the Senate Finance Committee ("SFC") used this "conceptual mark" for purposes of markup hearings, and it was to be converted into legislative language after passage out of the Committee. Chairman Hatch released his first modified mark on November 14th, and another at the end of the markup on November 16th (*see Description of the Chairman's Modification to the Chairman's Mark of the "Tax Cuts and Jobs Act*" and *Hatch Modification to Amendment #25 (Hatch #25*). Notably, the Chairman's first modified mark included a repeal of the ACA's individual mandate, altering the revenue scoring (please see www.jct.gov for the Joint Committee on Taxation's several scores relating to the amendments to both the House and Senate bills) and markup discussions of the bill. The Chairman's Mark, as amended, was passed out of the Committee on a party-line vote on November 16th.

Going forward, the bill will require approval by the full Senate. Legislative language for the Senate bill will likely be released shortly before Thanksgiving, and the full Senate is expected to vote on the bill the week after Thanksgiving. Assuming that the Senate passes a bill, the differences in the House and Senate bills will need to be reconciled. There are several variables that affect whether the bill will pass out of the Senate and how the two bills will be integrated, the most significant of which is compliance with the reconciliation instructions and the Byrd rule (under the Byrd rule, if the tax reform legislation increases the deficit

Upcoming Tax Events

Global Tax Disputes Forum

New York, NY
▶ December 7, 2017

State and Local Tax Breakfast Briefing

Santa Clara, CA
▶ December 13, 2017

Doing Business Globally

Mexico City
▶ January 18, 2018

40th Annual North America Tax Conference

Dallas, TX
▶ January 25, 2018

19th Annual Latin America Tax Conference

Miami, FL
▶ February 26-27, 2018

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

outside the 10-year budget window, then it will expire after 10 years). It is expected that the bills will be modified and reconciled by Republican leadership in order to comply with these rules and gain support over the next few weeks.

As a result, even though several hurdles must be overcome, it is possible that Congress will meet the President's deadline of passing tax reform by year-end. Clients should prepare to shift their focus from engaging with Congress on the content of legislation to engaging with Treasury and IRS on interpreting whatever is passed.

By: Joshua D. Odintz, Alexandra Minkovich, and Kathryn Rimpfel, Washington, DC

Proposed Regulations Clarify Registration-Required Obligations and Registered Form

On September 15, 2017, Treasury and the IRS proposed amendments to Treas. Reg. parts 1, 5f, and 46 to provide guidance on the definition of registration-required obligation and registered form. *See* 82 Fed. Reg. 43,720 (2017). The proposed regulations apply to obligations issued after March 18, 2012 and asks for comments to be submitted within 90 days of September 19, 2017.

In general, obligations are classified into either "bearer" or "registered" form. This classification has significant tax implications because a number of Code provisions impose sanctions on issuers and holders of registration-required obligations that are not issued in registered form. For example, section 163(f) denies the issuer a deduction for interest on a registration-required obligation that is not in registered form, while sections 871(h) and 881(c) exempt from federal income tax portfolio interest from sources within the US received by a nonresident alien or foreign corporation only if the obligation is in registered form. Likewise, section 165(j) denies the holder of a registration-required obligation a deduction for losses on that obligation if it is not in registered form, and section 312(m) provides that an issuer's earnings and profits are not reduced by interest paid on a registration-required obligation that is not in registered form. The proposed regulations provide much needed clarity in light of the recent law and changes in the marketplace.

Registration-Required Obligations

The proposed regulations provide guidance on the definition of registration-required obligation. Under section 163(f)(2)(A), the term "registration-required obligation" means any obligation other than an obligation that: (1) is issued by a natural person; (2) is not of a type offered to the public; or (3) has a maturity at issue of not more than one year. Consistent with prior regulations, in determining whether an obligation is of a type offered to the public, the proposed amendments continue to reference whether the obligation is "traded on an established market." *See* Prop. Reg. § 1.163-5(a)(2).

The proposed regulations also provide guidance for issuing pass-through certificates and, specifically, for determining whether pass-through certificates are registration-required obligations. Pass-through certificates generally are issued by investment entities that hold a pool of obligations such as mortgage loans. Treasury and the IRS received questions about the types of arrangements that would qualify as pass-through certificates. In response, Treasury and the IRS amended the definition of a pass-through certificate to provide that it may be issued by a grantor trust or similar fund. *See* Prop. Reg. § 1.163-5(a)(3)(i)(B).

Additionally, the proposed regulations eliminate an existing requirement that the fund hold a pool of loans. The proposed regulations replace that requirement with a new requirement that the fund principally hold debt instruments. As a result, an arrangement satisfying the definition of a registration-required obligation and the registered form rules is treated the same as a pass-through certificate, even if the arrangement concerns one underlying obligation or a co-ownership of one or more obligations. Finally, the proposed regulations treat an interest that evidences co-ownership of one or more obligations as a registration-required obligation if, standing alone, the interest satisfies the definition of a registration-required obligation. *See id.*

Definition of "Registered Form"

The proposed regulations amend the definition of "registered form" to take into account current market practices and changes made by the Hiring Incentives to Restore Employment Act (the "HIRE Act"). The HIRE Act had repealed section 163(f)(2)(B), which had provided special treatment of foreign-targeted bearer obligations.

Generally, a bond is treated as being in registered form if the right to the principal of, and stated interest on, the bond may be transferred only through a book entry. Treas. Reg. § 5f.103-1(c) provided the specific conditions for an obligation to be considered in registered form. Obligations that did not meet the conditions described in Treas. Reg. §5f.103-1(c) were treated as issued in bearer form. Since Treas. Reg. § 5f.103-1 was promulgated, market practices have changed significantly with respect to how interests in obligations were recorded and transferred. Today, many obligations trade in fully dematerialized form (*i.e.*, not represented by a physical certificate, and a clearing organization that is the registered holder of the obligation operates an electronic book entry system). Over the years, various developments (including Notice 2006-99, the HIRE Act, and Notice 2012-20) attempted to address ambiguities on how to apply the registered form rules to arrangements with no physical certificates.

Prop. Reg. § 1.163-5(b) resolves the ambiguities by amending the definition of "registered form" in three ways. First, the proposed regulations provide that an obligation is considered to be in registered form if it is transferable through a book entry system, including a dematerialized book entry system, maintained by the issuer of the obligation, an agent of the issuer, or a clearing organization. Second, the proposed regulations provide that an obligation represented by a physical certificate in bearer form will be considered to be in registered form if the physical certificate is effectively immobilized. A physical certificate is effectively immobilized if it is issued to and held by a clearing organization for the benefit of purchasers of interests in the obligation under certain arrangements. Third, the proposed regulations provide two circumstances in which the holders of obligations may obtain physical certificates evidencing the obligation in bearer form without causing the obligation to be treated as not being in registered form.

By: Angela Chang, Palo Alto

On Shaky Ground: Arguments without Factual Support Lead Tax Court to Soundly Reject Taxpayer's Bad Debt Deduction

In *Rutter v. Commissioner*, TC Memo 2017-174, the Tax Court denied the taxpayer's $8.6 million section 166 bad debt deduction. The Tax Court analyzed three questions regarding the taxpayer's bad debt deduction: (1) was the purported debt really debt or was it equity for tax purposes; (2) if debt, was it a business debt; and (3) if a business debt, did the taxpayer properly prove that the debt was partially or wholly worthless in the year the deduction was claimed. The Tax Court rejected the taxpayer's argument for deductibility on all three grounds finding that: (i) the purported debt was equity; (ii) even if had been debt, it was not a business debt; and (iii) even if the purported debt had been business debt, the taxpayer failed to prove the purported debt was worthless in the amount of the claimed deduction in the year the deduction was claimed. The Tax Court also imposed a 20% accuracy related penalty.

While superficially the taxpayer made arguments that, if accepted, could have justified the section 166 bad debt deduction, the taxpayer failed to offer up any proof to sustain his arguments. In its analysis of whether the advances constituted debt or equity, the Tax Court found that 8 of the 11 factors it analyzed strongly supported equity characterization. On the business vs. nonbusiness debt question, the taxpayer argued that he was in the business of being a lender to and a promoter of startup companies, but the Tax Court found that the taxpayer failed to offer any proof of these alleged businesses. As for proving that the debt was worthless or partially worthless in the year the deduction was claimed, the taxpayer provided a valuation showing a sharp decline in the value of the company in the year the partial worthlessness deduction was claimed. The Tax Court, however, found that the revenue projections and other information that the taxpayer provided to his valuation expert lacked factual support. The taxpayer's deduction was denied because his arguments were not built on a foundation of supporting facts.

Factual Background

The taxpayer in *Rutter* is 89-year old William J. Rutter, a world renowned biochemist. Though Dr. Rutter's tax planning was not exemplary, his career as a scientist was. He was the chair of the Biochemistry and Biophysics department at the University of California at San Francisco from 1969 until 1982. He has published more than 380 scientific articles and holds more than 25 patents. In 1981, Dr. Rutter founded the highly successful business, Chiron, to explore the business potential of developing solutions to human diseases using recently developed genetic technology. Chiron and Dr. Rutter were involved in the first sequencing of the HIV genome; the research that led to the creation of a vaccine for Hepatitis B; and the discovery, sequencing, and cloning of the Hepatitis C virus.

In 1999, Dr. Rutter formed a new startup company, iMertrikus ("IM"). IM specialized in developing technology systems to enable remote monitoring of patients' health. Unfortunately this business venture of Dr. Rutter was not as successful as Chiron. Until May 2005, Dr. Rutter did not own any stock in IM, and at no time did Dr. Rutter hold common stock in IM. The common stock of IM was owned by 70 individuals, some of whom were employees of IM or family members of Dr. Rutter. Throughout the life of the business, advances from Dr. Rutter were IM's main source of funding. IM treated these advances as debt on its books. In the beginning, Dr. Rutter and IM observed the formalities of papering the advances as debt. From 2000 to 2002, IM executed 39 convertible promissory notes payable to Dr. Rutter, one for each cash advance each bearing a 7% interest rate -- totaling $10.6 million. IM paid the interest on these notes to Dr. Rutter when due. Over time, however, Dr. Rutter and IM became sloppy. Between 2002 and 2005, IM issued promissory notes for only $3.4 million of $22 million total cash advances, and IM made no further interest payments. In 2005, Dr. Rutter converted the entire $43.4 million that he had advanced to IM into preferred stock.

After the preferred stock conversion, Dr. Rutter continued making cash advances to IM totaling $43.04 million from 2005 through 2009. IM did not execute and issue any additional promissory notes to Dr. Rutter, furnish any collateral, or pay any interest on this purported debt. During this time, Dr. Rutter's advances were IM's sole source of funding.

In December 2009, after a failed attempt to partner with a major investor, Dr. Rutter began assessing the financial condition of IM. In March 2010, Dr. Rutter and IM entered into a debt restructuring agreement and executed a consolidated promissory note and a certificate of debt forgiveness in the amount of $8.6 million. These documents were backdated December 31, 2009.

After the $8.6 million write down, IM continued operating and Dr. Rutter continued advancing funds to IM totaling $37.75 million from 2010 to 2013.

Debt vs. Equity Analysis

The Tax Court began by analyzing whether Dr. Rutter's advances to IM constituted debt or equity. The Tax Court employed the 11 factor test from the 9th Circuit case, *Hardman v. United States*, 827 F.2d 1409 (9th Cir. 1987). The 11 factors consisted of: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of repayment; (4) the right of the alleged lender to enforce payment; (5) whether the alleged lender participates in the management of the alleged borrower; (6) whether the alleged lender's status is equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the alleged borrower's capitalization; (9) if the advances are made by shareholders, whether the advances are made ratably or proportionate to their shareholdings; (10) whether the interest is paid out of "dividend money"; and (11) the alleged borrower's ability to obtain loans from outside lenders.

The Tax Court found that 8 of these facts either supported or strongly supported characterization of the debt as equity, instead of debt: (1) the advances were not papered as debt; no promissory notes or other documents evidencing the alleged indebtedness were issued; (2) the advances had no fixed maturity date because Dr. Rutter thought a maturity date would be "futile, senseless, and counter to the interests of all involved"; (3) Dr. Rutter stated that he expected to be repaid for his advances upon either a sale of IM to a third party or a third party investment; the Tax Court found this to be the hope of "the most speculative . . . equity investor"; (4) Dr. Rutter may have had a theoretical ability to enforce payment, but such enforceability was "nugatory" in the eyes of the Tax Court because the repayment would have to come from the taxpayer's own additional cash infusions; (5) though Dr. Rutter held only preferred stock, he held roughly 92% of

IM's capital structure and had complete control over IM as its sole financier; (7) Dr. Rutter's actions such as his failure to try to collect interest or enforce payment suggested he did not actually intend to create debt; (10) IM made no interest payments; and (11) no arm's length third party would have lent funds to IM "without insisting (at a minimum) on promissory notes, regular interest payments, collateral to secure the advances, and a personal guaranty from petitioner."

The Tax Court found that only two factors were neutral or slightly favored debt treatment: (8) IM had equity funding from the conversion of the $43 million of advances into preferred stock; and (9) there was not an identity of interest between Dr. Rutter in his capacity as a lender and as a shareholder (i.e., there were other shareholders). In addition, (6) while IM had no regular creditors, the Tax Court found that no regular creditor would have accepted an unsecured position in a loss-ridden company without a personal guarantee.

Based on the 11 factor test, the Tax Court concluded that the advances from Dr. Rutter were equity investments.

Other Elements of Section 166

The Tax Court went on to find that even if the advances were debt, Dr. Rutter failed to establish that the advances were made as part of a trade or business he was engaged in. Dr. Rutter argued that he was in the business of acting as a lender or promoter for startup companies. The Tax Court found there was no factual support in the record for either of these as a trade or business of Dr. Rutter.

Even if the debt had been a business debt, the Tax Court still found Dr. Rutter failed to prove the debt became partially worthless in 2009. In fact, the Tax Court believed that $8.6 million was not the amount of the debt that became worthless in 2009, but rather, approximated Dr. Rutter's income realized in 2009 from another of his startup companies. Dr. Rutter presented an expert's valuation report to support the worthlessness deduction claimed in 2009, but the Tax Court found that the expert's reliance on the revenue projections provided by IM's management was misplaced.

Imposition of an Accuracy Related Penalty

The Tax Court found that Dr. Rutter did not have substantial authority for his position because the authority for equity treatment was overwhelming. Further, while Dr. Rutter's accountant was a competent professional, Dr. Rutter failed to provide the accountant complete and accurate information so reliance on the professional advice defense was not available. Therefore, the Tax Court imposed a 20% accuracy related penalty on Dr. Rutter

Takeaways

While some may question whether Dr. Rutter's tax planning was unsophisticated, it contains valuable lessons. The taxpayer bears the burden of proving entitlement to a deduction. The arguments for a position are no stronger than the provable facts to support that position. For expert or professional advice to be reliable, it must be based on reliable facts and reasonable assumptions.

By: Amanda Swartz, Houston

Tax Court Swiftly Rejects IRS Argument that Closing Agreement is not Relevant in $3.3 Billion Transfer Pricing Case

In *Coca-Cola Co. et al v. Commissioner*, T.C. Dkt. No. 31183-15, the Tax Court rejected the IRS's motion for partial summary judgment to exclude from evidence a closing agreement between the parties covering prior tax years. In its motion, the IRS asked the Tax Court to decide as a matter of law that the closing agreement had no conceivable relevance to any issue before the Tax Court.

As part of the examination of Coca-Cola's 1987-89 tax returns, the IRS and the company entered into a closing agreement covering tax years up to and including 1995. The closing agreement included the "10-50-50 method" for calculating product royalties payable to Coca-Cola by its foreign affiliates. This method provided that the foreign affiliates would retain a routine return of 10% of their gross revenues and the residual operating income (after adjustments) would be split 50/50 between Coca-Cola and its foreign affiliates. The closing agreement provided penalty protection for the company up to and after 1995 so long as it continued to calculate the royalties paid by such foreign affiliates using the 10-50-50 method or another method later agreed to by the parties.

Coca-Cola continued using the 10-50-50 method to determine product royalties after the closing agreement expired for its 1996 through 2009 tax years. For 1996-2006, the IRS accepted the company's application of the 10-50-50 method (with one exception) and made no section 482 adjustments for the product royalties. For 2007-09, however, the IRS determined that Coca-Cola's royalty calculations under the 10-50-50 method were not arm's length and issued a notice of deficiency.

The Tax Court found that execution of the closing agreement is a "historical fact" that "provides the obvious starting point for any narrative of the events leading up to the . . . audit [at issue]." The IRS will be free to argue at trial and in its briefs that the closing agreement should have no probative value in determining whether the IRS abused its discretion in adjusting Coca-Cola's income, which even if true, does not mean the closing agreement has no relevance to any issue in the case. The Tax Court noted that, although the IRS did not assert penalties, it could seek leave to amend its answer to do so, in which case the closing agreement would have clear relevance.

The Tax Court further stated that the Mexican foreign tax credit issue between the parties is one example in which the closing agreement is relevant because it helps explain the basis on which the Mexican branch paid income tax in Mexico. The Tax Court said there could be additional instances where the closing agreement may be relevant of which it is currently unaware.

Interestingly, the Tax Court called the IRS's motion "odd" because rather than filing a motion *in limine* to exclude the closing agreement from evidence for relevancy, the IRS filed a partial motion for summary judgment seeking to rule that a historical fact, as a matter of law, "can have no conceivable relevance to any issue before the Tax Court." Citing Tax Court Rule 121(a), the Tax Court doubted that this was a proper subject for summary judgment because the IRS did not seek summary adjudication in its favor on a legal issue in controversy. The Tax Court said it would be "imprudent" to grant a motion of this type six months before hearing evidence at trial, and it denied the motion on its merits.

This attempt by the IRS to disavow a prior agreement with a taxpayer is just the latest instance in a string of recent transfer pricing cases that have landed in Tax Court. In *Medtronic v. Commissioner*, T.C. Memo. 2016-112 (2016), currently on appeal in the US Court of Appeals for the Eighth Circuit, the dispute arose when the IRS opted to no longer follow the terms of a "memorandum of understanding" that set out the parties' agreed transfer pricing methodology for the licenses of intangible property relating to the manufacturing and distribution of implantable medical devices. In the other case, *Eaton v. Commissioner*, T.C. Memo. 2017-147 (2017), the Tax Court held that the IRS abused its discretion in cancelling two advance pricing agreements containing the parties' agreement on the best method for determining arm's-length prices for the purchase of certain products.

To date, the IRS has not fared well in litigating cases in which it has reneged on a prior deal with a taxpayer. From efficiency and economic perspectives, let alone institutional credibility, one must question why the IRS continues to negotiate transfer pricing resolutions that it believes create arm's-length results, only to later squander its own resources, and those of taxpayers, in attempting to compel different "deals" through the hands of a court.

Coca-Cola Co. et al v. Commissioner is calendared for trial starting on March 5, 2018.

By: Kent Stackhouse, Washington DC

Hateful Eight

On October 4, 2017, Treasury issued a *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens* pursuant to Executive Order 13789 (the "Report") (follow link to view full document, also posted at treasury.gov). The Report recommends actions to eliminate or mitigate the burdens imposed on taxpayers by the "Hateful Eight" regulations—those identified in Notice 2017-38, issued in July 2017, which Treasury determined met the criteria listed in Executive Order 13789 (the "EO") (*see*, *Notice 2017-38*). President Trump had signed the EO in April, instructing Treasury to review and identify all significant tax regulations issued on or after January 1, 2016, and also to identify which of those significant regulations (1) imposed an undue financial burden on US taxpayers, (2) added undue complexity to federal tax laws, or (3) exceeded the IRS's statutory authority.

The actions recommended by Treasury and the IRS in the Report with respect to the Hateful Eight regulations are summarized below.

Final and Temporary Regulations Under Code Section 987

Final and temporary regulations under section 987 on income and currency gain or loss with respect to a "Section 987 Qualified Business Unit" have been the subject of a previous client alert "*US Treasury Releases Final & Temporary Section 987 Regulations,*" distributed on January 9, 2017. In short, the final section 987 regulations were released on December 7, 2016, and addressed a number of issues under Subpart J. The section 987 regulations represented a significant departure from existing practice for the vast majority of US-based multinationals. These regulations also imposed significant compliance burdens on US taxpayers that were subject to them. The effective date for the vast majority of the section 987 Regulations is the applicable taxpayer's first taxable year beginning after December 6, 2017.

On October 2, 2017, the IRS released Notice 2017-57, which announced that the IRS intends to amend the regulations under section 987 to defer the applicability date of the final regulations by one year. The Notice further provided that the Treasury Department and the IRS are considering changes to the final regulations that would allow taxpayers to elect to apply alternative rules for transitioning to the final regulations and alternative rules for determining section 987 gain or loss.

The Report further clarified the scope of these proposed changes to the section 987 Regulations. The Report provides that Treasury intends to propose modifications to permit taxpayers to elect a simplified method of calculating foreign currency gain or loss and translating income or loss. One variation under consideration would aim to be consistent with financial accounting rules. However, to address concerns regarding a taxpayer's ability to strategically time the recognition of foreign currency gains or losses, Treasury intends to impose timing restriction on such recognition events. The Report noted that Treasury is considering limitations whereby Section 987 losses could only be recognized to the extent of section 987 gains. Alternatively, the Report noted that Treasury is also considering limits that would defer recognition of all section 987 losses and gains until the earlier of (i) the year in which the trade or business conducted by the section 987 Qualified Business Unit ceases to be performed by any member of its controlled group or (ii) the year in which substantially all of the assets and activities of the Qualified Business Unit are transferred outside of the controlled group.

Finally, the Report noted that Treasury is considering alternatives to the transition rules in the final regulations. Such changes may allow taxpayers to carry forward unrecognized section 987 gains or losses, whereas the section 987 Regulations would have required a fresh start transition method in which there would be no carry forward of unrecognized section 987 gains or losses.

Proposed Regulations Under Code Section 103

Proposed regulations issued under section 103 require a "political subdivision" that can issue tax-exempt bonds to not only possess "significant sovereign power," which was the requirement under the existing regulations, but also to demonstrate a "governmental purpose" and "governmental control." Although Treasury and the IRS believe that some enhanced standards for qualifying as a "political subdivision" able to issue tax-exempt bonds may be appropriate, the Report recommended that the proposed regulations be withdrawn in their entirety because of the unjustified far-reaching burdensome impact they would have on existing legal structures. The proposed regulations were formally withdrawn on October 20, 2017. The Report left open the possibility that Treasury and the IRS could issue more targeted guidance on this issue in the future.

Temporary and Proposed Regulations Under Code Sections 707 and 752

Temporary and proposed regulations issued in the partnership tax area brought about two major changes. First, they restricted the ability of a partner to use certain types of guarantees of a partnership's liability to allocate the guaranteed amount of the liability to that partner for purposes of determining the partner's outside basis in its partnership interest. For these purposes, the temporary and proposed regulations generally ignore so-called “bottom dollar guarantees,” namely, guarantees of a partnership’s liability that do not give the creditor the ability to recover from the guarantor-partner from the first dollar of loss.

Second, the temporary and proposed regulations restricted the ability of a partnership to distribute debt proceeds to a contributee partner in a non-taxable manner, as an exception to disguised sale treatment, following the contribution of property by that partner to the partnership. The “debt-financed distribution” exception provides that any such debt proceeds distributed to the contributing partner are excepted from disguised sale treatment to the extent of such partner’s allocable share of the debt. When determining the partner’s share of the debt for this purpose, the temporary and proposed regulations ignore any guarantees by the partner, instead treating the debt as “nonrecourse debt” which is generally allocable to the distributee partner only to the extent of the partner’s share in partnership profits, regardless of whether the debt is guaranteed.

The Report provides that Treasury and the IRS are considering whether the temporary and proposed regulations should be revoked, and the prior regulations reinstated, which would allow a property-contributing partner to guarantee partnership debt and receive a distribution of the proceeds of that debt in an entirely tax-free manner as an exception to disguised sale treatment. The Report states that the temporary and proposed regulations in this area change the tax treatment of many partnerships and that Treasury believes that such a far-reaching change should be studied systematically before new regulations are issued.

By contrast, Treasury and the IRS believe that the temporary and proposed regulations relating to “bottom-dollar guarantees” should be retained, because the prior rules permitted sophisticated taxpayers to create basis artificially without meaningful real economic risk of loss and thereby defer or shelter income tax liability. Therefore, although Treasury and the IRS will continue to consider comments relating to the technical issues raised by these regulations, they do not plan to propose substantial changes to them.

Temporary Regulations Under Code Section 337(d)

The Protecting Americans from Tax Hikes Act of 2015 limited the ability of a C corporation to separate its REIT-eligible assets from its other assets using a tax-free spin-off, thereby allowing the unrecognized built-in gain in the REIT-eligible assets from escaping double-taxation, since REITs are essentially subject to only one layer of tax (at the shareholder level) if they distribute all of their earnings and profits in the year in which they are realized. Temporary regulations issued under section 337(d) attempted to implement this legislative change by imposing harsh, bright-line rules that can potentially result in otherwise valid transactions in which a C corporation spins off another C corporation losing tax-free treatment upon the occurrence of unrelated non-abusive transactions between one of the corporations involved in the spin-off and a REIT within 10 years of the spin off.

In the Report, Treasury and the IRS agreed that the temporary regulations could produce inappropriate results in some cases. Therefore, Treasury and the IRS are considering revising these regulations to limit the potential for recognition of taxable gain to a more appropriate amount as a result of subsequent transactions involving one of the corporations involved in a tax-free spin off and a REIT, in a manner that more likely tracks the legislative intent of Congress.

Final Regulations Under Code Section 367(d)

Section 367 generally imposes immediate or future US tax on transfers of property to foreign corporations, subject to certain exceptions. For intangibles within the meaning of Code Section 936(h)(3)(B), a transfer to a foreign corporation subjects the transfer to sale treatment in exchange for amounts which would have been received annually over the useful life of the property, or in the case of a disposition following such transfer, at the time of disposition, commensurate with the income attributable to the intangible.

The potential reach of section 367(d) was expanded by Final Regulations, which intended to tax the transfer of foreign goodwill and going concern value, in addition to the intangibles expressly included in section 936(h)(3)(B). Comments on both these regulations and Notice 2017-38 noted that the legislative history of section 367(d) supported the exclusion of foreign goodwill and going concern value, in accordance with the express language of section 936(h)(3)(B).

In the Report, Treasury and the IRS announced that they intend to substantially revise these regulations to provide an exception for non-abusive transactions. Specifically, Treasury and the IRS mentioned expanding the scope of the already-existing active trade or business exception in these rules to cover situations with limited potential for abuse, as well as situations presenting administrative difficulties, including valuation.

Other Provisions

In addition to the five items discussed above, the Report suggested the following additional actions:

- For regulations under Code Section 7602, regarding participation in a summons interview, amending the regulation to limit outside attorney involvement in examinations;
- For regulations under Code Section 2704, regarding valuation of interests in family-controlled entities for estate and gift tax purposes, withdrawing the regulations entirely; this was accomplished on October 17, 2017;
- For regulations under Code Section 385, retaining the per se and funding rules pending resolution through tax reform efforts, but delaying the effective date of the documentation rules. The documentation rules were formally delayed on July 28, 2017, and now apply to instruments issued or deemed issued on or after January 1, 2019. These rules, however, may never come into effect, as advisers in Treasury's Office of Tax Legislative Counsel said on November 8 that Treasury and the IRS would propose the wholesale withdrawal of the documentation rules.

By: Josh Richardson, Maher Haddad, and Daniel Wharton, Chicago

DDRA Capital, Inc. v. KPMG

On September 6, 2017, the Third Circuit issued its decision in *DDRA Capital, Inc. v. KPMG, LLP*. The Court granted KPMG, LLP summary judgment on certain claims brought by two participants in a tax shelter, but it also reversed the District Court's grant of summary judgment for KPMG with respect to the participants' negligence claims, as well as the District Court's dismissal of the participants' RICO claim. The suit's origins date to a 1999 transaction relating to the purchase and finance of the Delta Downs Racetrack in Louisiana by Shawn Scott, DDRA Capital's ("DDRA") then-president and sole shareholder. In 2001, with the assistance of John Baldwin, the track was sold at a $74 million profit, with Baldwin receiving a $10 million fee as well as interest on a $17 million loan made to finance the 1999 transaction.

Scott and Baldwin (together, the "Plaintiffs") chose a tax strategy suggested by Carl Hasting of KPMG known as the Short Option Strategy ("SOS")—the strategy had been flagged by the IRS for disallowance in Notice 2000-44. The rationale behind the SOS transaction was to use options (which, economically, largely offset each other) in order to create a tax loss when the options were transferred to another entity. In doing so, a taxpayer was able to put at risk only the net premium paid to secure the options.

DDRA bought long options on Brazilian and Mexican currency for $49,238,000 and sold short options on the same for $48,625,000—thus, it only spent $613,000 on the options. Thereafter, DDRA transferred both the long and short options to a partnership. Relying on an old Tax Court opinion, DDRA then calculated its basis in the partnership solely based on the value of the long options—thus, DDRA calculated its basis in the partnership at $49,238,000 instead of the net loss of $613,000 it had actually accrued on the transaction. Finally, DDRA disposed of all the options at an amount near the actual net loss ($613,000) of the offsetting options, which created a tax loss (notwithstanding the absence of an economic loss) at the partnership level approximately equal to the value of the long options.

As a result of the SOS transactions, on their 2001 tax returns, DDRA and Baldwin claimed ordinary loss deductions of $48 and $22 million, respectively. Ultimately, given the lack of economic substance and Notice 2000-44, the IRS disallowed the deductions. In addition, because it had been promoting tax shelters, including but not limited to the SOS structure, KPMG entered into a deferred prosecution agreement with the government to avoid criminal responsibility. Thereafter, Plaintiffs accepted an IRS global voluntary settlement offer and paid all associated back taxes, interest, and penalties. Plaintiffs then sued KPMG under Nevada law for fraud, negligent misrepresentation, negligence, and breach of fiduciary duty as well as for violation of the Racketeer Influenced and Corrupt Organizations Act (RICO). At the District Court level, the court granted summary judgment in favor of KPMG on all claims. The immediate appellate suit, decided by the Third Circuit, affirmed and reversed parts of the District Court's decision.

Fraud and Negligent Misrepresentation Claims

The Third Circuit affirmed the District Court's grant of summary judgment against the Plaintiffs, finding that the Plaintiffs could not have justifiably relied on Hasting's and KPMG's misrepresentations. The Third Circuit based its decision on the Plaintiffs' ignorance of certain red flags associated with the transaction, including: (i) the Plaintiffs' knowledge that they would suffer no actual losses yet still planned on claiming losses as deductions; (ii) the fees the Plaintiffs paid were nearly equivalent to their investments; (iii) there existed a prearranged "turnkey" transaction that would produce just the right amount of losses; and (iv) in spite of the SOS transaction, the Plaintiffs would still make a profit. Thus, the Third Circuit concluded that the Plaintiffs, had they properly investigated the transaction, would have discovered it was illegal and therefore could not claim justifiable reliance.

Negligence Claims

The Third Circuit reversed the District Court's grant of summary judgment against the Plaintiffs because the Plaintiffs produced sufficient evidence of proximate cause. Under Nevada law, a defendant is responsible for all foreseeable consequences proximately caused by its negligent acts. The Plaintiffs considered a number of alternatives prior to committing to the SOS transaction, including pursuing a Code Section 1031 exchange, investing in companies with net operating losses, and moving to the Virgin Islands. The Plaintiffs alleged that it was only Hasting's insistence on using the SOS transaction that ultimately caused the Plaintiffs to pursue that strategy, and not others. The Third Circuit agreed with the Plaintiffs that there was sufficient evidence to introduce to a jury with respect to the proximate cause element of their negligence claim.

Fiduciary Duty Claims

The Third Circuit affirmed the District Court's grant of summary judgment for KPMG on the Plaintiffs' breach of fiduciary duty claims. The court focused on whether there was a confidential or special relationship between the Plaintiffs and KPMG. Hasting, when asked, refused to provide details of the transaction to the Plaintiffs. Furthermore, a confidential or special relationship requires that a reasonable person have a particular reason to be confident and reliant on the purveyor of advice. In the immediate situation, the Plaintiffs had an ordinary accountant-client relationship, and KPMG did not go "above and beyond" the services it would provide for other clients. Thus, the Third Circuit concluded that (i) the evidence demonstrated that the Plaintiffs had an arm's length relationship with Hasting and KMPG; and (ii) the Plaintiffs' knowledge of the scheme's loss-generation mechanism demonstrated that any confidence reposed in KPMG was unreasonable.

RICO Claims

The Third Circuit reversed the District Court's dismissal of the Plaintiffs' RICO claim. The dismissal of this claim was reversed on res judicata grounds in light of the Third Circuit's finding that the Plaintiffs produced sufficient evidence to reach a jury on proximate cause.

Takeaways from *DDRA Capital*

The Third Circuit's decision in *DDRA Capital, Inc. v. KPMG LLP* provides an interesting look back to the heyday of tax shelters nearly two decades ago. As background, the 1990s tax shelters proliferated in a pre-Sarbanes-Oxley environment in which firms commonly marketed tax avoidance transactions as products. The issue was not limited to accountants, as lawyers and bankers also attempted to sell such high-value "products," focusing less on merely providing tax advice to support legitimate business transactions. Some factors contributing to the explosion of tax shelters during this time included: (i) an inherent conflict of interest for accounting firms that both provided tax advice and auditing services to the same companies; (ii) an objective to earn high fees calculated as a percentage of tax savings; (iii) large-scale firm marketing programs that targeted clients who might have an interest in tax avoidance; and (iv) an overwhelmed IRS that had difficulty in processing complex tax returns and timely asserting deficiencies attributable to tax shelters.

The ramifications of those transactions, however long ago they occurred, remain with both the Plaintiff and KPMG as they continue to litigate. The decision provides a reminder for taxpayers and tax advisors alike that tax-driven transactions must be approached with caution. The Plaintiffs blindly relied on Hasting and on his firm's sterling reputation. As they came to find, merely relying on the advice of a reputable firm, then pleading ignorance, does not provide protection from the law. Had the Plaintiffs insisted on seeing the details of the transaction, or sought an opinion from independent legal counsel, they may have avoided the SOS structure and the eventual back taxes, interest, and penalties that resulted.

Today, tax advisors may perceive the time of tax shelters to be long over, and may feel a safe distance away from structures like SOS, which the IRS had already targeted in a notice. Cases involving global firms pushing tax avoidance products are fairly rare, at least compared to the late 1990s. Nonetheless, practitioners would do well not to forget the past, lest they be doomed to repeat it. KPMG obtained summary judgment with respect to the fiduciary, fraud, and misrepresentation claims, but it still has to contend with the negligence and RICO claims, and thus its entanglement with the Plaintiffs remains far from over.

By: Michael Tenenboym, Chicago

Private Letter Ruling 201721002 - Favorable International Spins Ruling

The IRS recently issued a favorable private letter ruling, PLR 201721002, involving a leveraged reverse *Morris Trust* ("RMT") transaction with helpful guidance concerning such transactions. The ruling also helps taxpayers navigate a spin involving hook stock.

The Facts

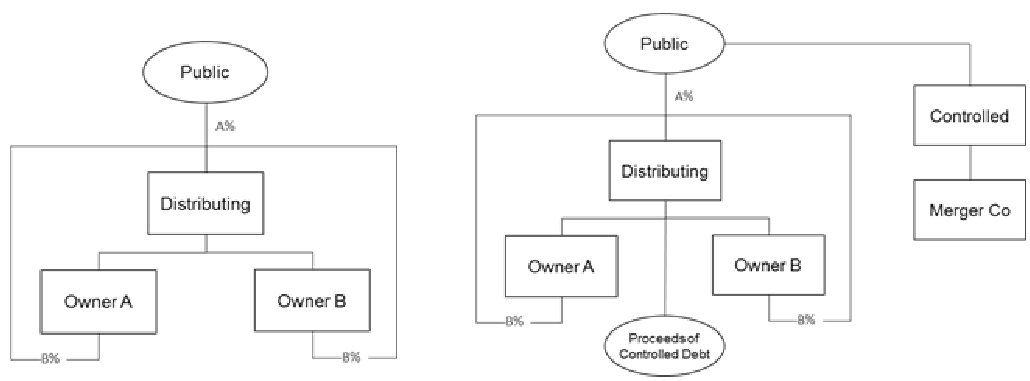
In a spinoff transaction, a parent company, (i.e. distributing), typically contributes assets to a subsidiary (i.e. controlled) and then distributes controlled to its shareholders. In the ruling, distributing ("Distributing") operates two business lines and wishes to separate the two businesses. To accomplish this, Distributing forms a subsidiary ("Controlled") and Controlled forms a subsidiary ("Merger Sub"). Distributing then contributes a trade or business (i.e. "Business B") to Controlled in exchange for Controlled stock, Controlled debt (and proceeds), and Controlled's assumption of Business B liabilities. Distributing, within 18 months, uses the cash to repay Distributing debt or distributes the cash to its shareholders. Additionally, investment banks associated with the transaction ("Investment Banks") purchase a portion of Distributing's debt and agree to exchange it for Controlled debt. In order for the Controlled debt to avoid being characterized as boot, the Distributing and each Investment Bank enter into an agreement to exchange the Controlled debt for the Distributing debt no sooner than 5 days after the Distributing debt is acquired by the Investment Bank on the market. The closing of the foregoing debt for debt exchange can occur no sooner than 14 days after the purchase of the Distributing debt by the Investment Bank (the "5/14 Day Rule").

In the ruling, A% of Distributing is owned by its wholly owned subsidiaries, "Owner A" and "Owner B" (i.e. hook stock). Finally, Distributing distributes Controlled stock to its public shareholders (excluding Owner A and Owner B) in a partial pro rata spinoff. In exchange for their hook stock, Owner A and Owner B receive additional Distributing common stock – and not Controlled stock.

Controlled will, immediately after completion of the distribution of Controlled stock, acquire all of the stock of Merger Co, an unrelated corporation, in exchange for Controlled stock (in a merger with Merger Sub) in a transaction where Controlled's pre-combination shareholders will retain more than 50% of the stock voting power and value of Controlled. Controlled may carry out open-market share repurchases or accelerated share repurchases following the combination.

The private letter ruling allowed the taxpayer, Distributing, to utilize contributions from "hook-stock" to help separate the business lines in a tax free contribution from Owner A and Owner B to Distributing and from Distributing to Controlled. Controlled would then have its stock distributed from Distributing to the Public.

A simplified before and after structure is illustrated here:



The Ruling

The IRS ruled as follows with regard to the foregoing restructuring:

1. The Investment Banks adhering to the 5/14 Day Rule are respected as "creditors" of Distributing for purposes of section 361(c)(3), i.e., the distribution of the Controlled debt to the Investment Banks in the investment bank debt exchange will be treated as a distribution pursuant to a plan of reorganization. Accordingly, no gain or loss is recognized by Distributing on account of the distribution.

2. If Distributing's exchange debt constitutes "securities" and the Controlled debt to be transferred in cancellation of the exchange debt "has comparable terms" (e.g., the debt has comparable remaining period to maturity, but not necessarily comparable interest rate), then the Controlled debt will also constitute securities for purposes of sections 355 and 361. See Rev. Rul. 2004-78. Accordingly, no gain or loss will be recognized by Distributing on the receipt of the Controlled debt.

3. Distributing's completion of the investment bank debt exchange, and any distribution of the Controlled debt to Distributing creditors (other than the Investment Banks), does not impact the tax-free nature of the Controlled contribution, the external distribution to public shareholders, or the investment bank debt exchange for purposes of section 355 and 361.

4. The repayment of Distributing debt existing at the time of the receipt of Controlled debt, and any distribution or exchange by Distributing of the Controlled debt (including the investment bank debt exchange), will be treated as being distributed pursuant to a plan of reorganization for purposes of section 361(b) and (c).

5. The overlapping ownership rules allow for the increase in Controlled public shareholders' ownership percentage of Controlled stock after the Combination to be offset by their decrease in stock ownership percentage from being a Controlled shareholder immediately before the Combination. Accordingly, Distributing is able to sell 50% of Controlled without triggering section 355(e).

6. The intercompany payments are permitted to net out in determining the net amount paid to Distributing, and as long as it is paid out to Distributing's shareholders or creditors within 18 months it will not constitute boot. The Investment Bank debt exchange does not impact the tax free nature of Distributing's contribution to Controlled because the cash is distributed to Distributing's shareholders and it is used to pay existing Distributing debt if all paid within 18 months of receiving the debt proceeds from Controlled.

7. To the extent the share repurchases by Controlled are treated as part of a plan or series of related transactions with the external distribution, the share repurchases will be deemed to be independent from spin and done in a pro rata fashion. Accordingly, these repurchases will have no effect on the relative percentages of the stock of Controlled owned by the former Controlled shareholders and by the former shareholders of Merger Co for purposes of section 355(e). This will facilitate post-merger stock buyback by Controlled's.

8. The initial designations of the post-combination members of the Controlled board of directors will not affect the determination of the total voting power or value of the stock of Controlled acquired for section 355(e).

9. The IRS blessed Distributing issuing additional Distributing stock to Owner A and Owner B in exchange for the spin-off business assets. In this way, neither Owner A or Owner B needed to take shares back in Controlled, the new company. And rather than having to distribute Controlled stock to the holders of the hook stock, the ruling allows the holders of hook stock to receive additional stock of Distributing with the consequence that the Controlled stock is distributed, in its entirety, outside the Distributing group.

   The presence of "hook stock" has complicated transactions in the past. Generally, hook stock shareholders are often respected as shareholders of the parent corporation, and a subsequent actual or deemed distribution of hook stock creates a recognized gain under section 311(b), wherein the gain is immediately triggered under Treas Reg. 1.1502-13 because the built-in gain hook stock is eliminated. The ruling opens a path to use a leveraged RMT with hook stock that takes away some of the disadvantages of subsequently dealing with the hook stock.

By: Jason Graham, Dallas

New Jersey "Preserves" Ability to Tax Out-of-State Corporate Limited Partners

Reinvigorating a nexus ghost from tax years past, the New Jersey Tax Court recently looked to the unitary business principle — or, at least, the hallmarks of a unitary business — to conclude that a corporate limited partner was subject to tax in New Jersey by virtue of its interest in a partnership that was doing business in the state. In *Preserve II, Inc. v. Director, Div. of Taxation*, Docket No. 010920-2013 (N.J. Tax Ct. Oct. 4, 2017), the petitioner, an out-of-state corporate limited partner in two partnerships that were doing business in New Jersey, argued that it lacked nexus with New Jersey by virtue of its limited partner status. The Division of Taxation (the "Division") argued that, *inter alia*, because the petitioner was engaged in a "unitary business" with the partnerships, it had nexus in New Jersey.

Although the New Jersey Tax Court had previously held that a nonresident limited partner did not have nexus in New Jersey for corporation business tax purposes when its only contact with the state was its interest in a New Jersey partnership, the court in *Preserve II* ruled that where the corporate limited partner actually manages and operates the partnership (i.e., the same individuals managed and operated both the limited partner and the partnerships to serve one common operational purpose), the partner is subject to tax. While the court did not directly conclude that the unitary business principle was a corollary for nexus — as the Division had — it did rely on many of the characteristics of a unitary business to conclude that the limited partner had New Jersey nexus. The blurring of the lines between the unitary business principle (an apportionment concept) and nexus (a jurisdictional concept) is troubling and reminiscent of a headline-grabbing appellate court decision issued several years ago in Maryland, in which the court directly employed the unitary business principle to establish nexus over an out-of-state company — a holding that was later rightfully rejected by Maryland's highest court.

For more discussion on the *Preserve II* case, please see *New Jersey "Preserves" Ability to Tax Out-of-State Corporate Limited Partners* on the SALT Savvy blog, available at www.saltsavvy.com.

Delaware Issues its Final Unclaimed Property Regulations Forcing Companies Under Audit to Make Immediate Decisions

On October 1, 2017, the Delaware Department of Finance (the "DOF"), the state governmental body ultimately responsible for unclaimed property audits, published its final regulations. The DOF regulations, which became effective October 11, 2017, establish the guidelines and standards for administering an unclaimed property audit. Overall, the final DOF regulations retain the severely criticized estimation methodology and ignore many of the constitutional issues raised by the federal court in *Temple-Inland Inc. v. Cook*, 1:14-cv-00654 (D. Del. June 28, 2016) ("*Temple-Inland*"). More specifically, the final DOF regulations, in direct conflict with *Temple-Inland*, continue to assert that the DOF can estimate a holder's Delaware unclaimed property liability for years for which a holder no longer has books and records based on all unclaimed property identified in a

Baker McKenzie
North America Tax

Chicago
+1 312 861 8000

Dallas
+1 214 978 3000

Houston
+1 713 427 5000

Miami
+1 305 789 8900

New York
+1 212 626 4100

Palo Alto
+1 650 856 2400

San Francisco
+1 415 576 3000

Toronto
+1 416 863 1221

Washington, DC
+1 202 452 7000

sample period, even property escheatable to other states. Ultimately, because of this and other issues, we expect that Delaware will face more unclaimed property disputes and litigation going forward.

However, with the release of the final DOF regulations, holders can take solace in the fact that they now have some certainty when it comes to the new unclaimed property landscape in Delaware; and thus, holders can begin to evaluate their audit and compliance positions with respect to Delaware's unclaimed property law. Of immediate concern, holders currently under audit with the DOF will have until December 11, 2017 (i.e., 60 days from the effective date of the DOF regulations), to convert their existing audit to the Secretary of State's ("SOS") voluntary disclosure agreement ("VDA") program or the DOF expedited audit process – both of which would result in waiver of interest and penalties. Given the fast-approaching December 11, 2017 deadline, holders currently under audit need to make some immediate decisions with respect to their audit position in Delaware and, for this reason, should consult their advisors about the strategic benefits and risks associated with remaining in their existing audit versus converting to the SOS VDA program or expedited audit process.

For more discussion on the new unclaimed property landscape in Delaware, please see the SALT Savvy blog post from October 23, 2017, *UPDATE: The New Norm For Abandoned and Unclaimed Property in Delaware*, available at www.saltsavvy.com.

Join Baker McKenzie in New York this December for the Second Annual Global Tax Disputes Forum

We invite you and your colleagues to join Baker McKenzie's leading US and international tax practitioners in New York on December 7 for our Global Tax Disputes Forum, ***Defending Yesterday, Today and Tomorrow: The New Normal in Global Tax Disputes***. This day-long conference will offer current insights for defending your past, present and future tax positions around the globe.

Plenary session topics include:

- **Uncertainty in the United States and Its Effect on Tax Disputes**
  2017 has been a year of uncertainty in the United States. Tax reform is forthcoming, but no one knows exactly what that will look like or when it will be implemented. The internal workings of the Internal Revenue Service continue to be a moving target, and IRS Appeals appears to be losing its independence. This session will explore how all of these changes may impact current and future tax disputes.

- **Let's Make a Deal - Alternative Dispute Resolution Options**
  The application of BEPS principles and measures and the foreseeable evolution in the international arena requires effective mechanisms to avoid double or undue taxation. This session will provide a practical overview of the available mechanisms, including MAP and arbitration, and examine the pros and cons of alternative dispute resolution versus litigation.

www.bakermckenzie.com

Baker & McKenzie
300 East Randolph Drive
Chicago, Illinois 60601, USA
Tel: +1 312 861 8000
Fax: +1 312 861 2899

- **Resolving Transfer Pricing Disputes Around the Globe**
  Transfer pricing litigation is on the rise as taxpayers have been increasingly unable to satisfactorily resolve their cases at the audit level. This latest wave of transfer pricing litigation has underscored the importance of being prepared to defend your transfer pricing positions from the very beginning of the audit. This session will explore how to prepare and defend transfer pricing positions in today's environment.

For a full agenda and details on how to register, visit our event page.

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