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Here Today, Gone Tomorrow: Ninth Circuit Issues, then Withdraws, Opinion in *Altera*

On July 24, 2018, a panel of the U.S. Court of Appeals for the Ninth Circuit issued a majority opinion and a dissenting opinion in *Altera Corp. & Subsidiaries v. Commissioner* (Case Nos. 16-70496 and 16-70497). The majority opinion would have reversed the unanimous U.S. Tax Court decision (145 T.C. 91 (2015)) and upheld the validity of Treas. Reg. § 1.482-7A(d)(2) (2003), which provided that "costs" to be shared in connection with a qualified cost sharing arrangement must include the costs of employee stock-based compensation.

Just 15 days later, on August 7, 2018, the Ninth Circuit withdrew those opinions so that a newly constituted panel can consider the appeal. Specifically, Judge Susan P. Graber has been appointed as the third member of the panel (in lieu of Judge Reinhardt, who unexpectedly passed away four months prior to the release of the *Altera* opinions on July 24). Oral re-argument is scheduled for October 16.

As a result of the withdrawal of the Ninth Circuit opinions in *Altera*, the status quo is restored to the time before the Ninth Circuit panel opinions were published. Specifically, the Tax Court decision remains in place as we await further development from the Ninth Circuit.

By: Amanda Kottke, Palo Alto

How I Spent My Summer Vacation—Reading Proposed Regulations

August, usually a quiet month for beach vacations and back-to-school shopping, is, instead, turning out to be a hive of activity. As of the time this article was written, Treasury had released two sets of proposed regulations implementing the Tax Cuts and Jobs Act (TCJA) (P.L. 155-97)—Section 965 (deemed repatriation) and Section 168(k) (immediate expensing). More regulations are on the way.

The proposed Section 965 regulations won't make any "recommended beach reading" lists but, for tax practitioners, they are required reading this August. The Cliffs' Notes version (otherwise known as Baker McKenzie's client alert),will be distributed soon.

Proposed regulations implementing Section 199A are currently with the Office of Management and Budget (OMB) for review, and we understand that Treasury and the IRS are working on proposed regulations under Section 163(j), with the goal of releasing those regulations in September. Guidance on the international provisions—GILTI, FDII, the hybrid rules, and BEAT—will likely be released from October through December. Finally, the latest version of the Priority Guidance

Upcoming Tax Events

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► September 20-21, 2018

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► October 10, 2018

Dallas, Texas
► October 18, 2018

19th Annual International Tax and Trust Training Program

New York, NY
► October 16, 2018

Miami, FL
► October 18, 2018

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Plan lists 18 items to be released as part of the "initial implementation" of the TCJA, including guidance under Section 162(m) (employee compensation), Sections 162(f) and 6050X (settlement deductibility), and Section 451 (accounting treatment of certain items).

Taxpayers should review the proposed regulations and work with their advisors to identify next steps. We expect that Treasury and IRS will be able to answer some of the open questions in proposed regulations, and taxpayers should consider commenting on the proposed regulations and speaking at the hearings that Treasury and IRS will hold on the proposed regulations. Given the significance of the TCJA (from both a technical tax and political perspective), we expect a greater-than-usual number of comments to be submitted from a more extensive group of commenters. We expect not just taxpayers, trade associations, and advisor groups (like bar and accounting associations) to weigh in on Treasury's actions, but also academics, think tanks, non-governmental organizations, and even members of Congress. As a result, taxpayers who are relieved to find that Treasury issued guidance favorable to them should not be content to wait for final regulations, but should consider commenting in support of Treasury's guidance to provide a counterpoint to any negative comments.

Other open questions will be left unanswered by Treasury and IRS, but that does not mean that taxpayers lack options. For example, the proposed Section 168(k) regulations did not address what has come to be known as the "QIP (Qualified Improvement Property) glitch". Affected taxpayers know that Congress consolidated three existing categories of 15-year property—qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property—into a single category, QIP. However, Congress neglected to add QIP to the list of 15-year property in the statutory text of the TCJA. The legislative history makes it clear that Congress intended to include QIP on the list of 15-year property, thus making QIP eligible for immediate expensing. Despite requests from taxpayers, Treasury did not fix the glitch in the proposed regulations. Affected taxpayers are instead pursuing a technical correction—but the list of technical corrections is long, its constituents are many, and the legislative vehicles are few.

Another apparent drafting error in the TCJA that Treasury and the IRS may not be able to address in guidance is the "NOL effective date error." Section 13302(b) of the TCJA prohibits NOL carrybacks. The statutory text says that section 13302(b) should be effective for tax years *ending* after December 31, 2017, while the legislative history describes the provision as being effective for tax years *beginning* after December 31, 2017, which makes the intended effective date for fiscal year taxpayers unclear. There is general consensus that the legislative history is correct and that Congress made an error in drafting, which should be addressed in a technical correction.

While the QIP glitch and the NOL effective date error are the best candidates for technical corrections legislation in the lame duck session, their passage is by no means assured. Taxpayers who are affected by either provision should strategize to keep the issue in front of their members of Congress and advocate for legislation.

In summary, taxpayers should spend time reviewing the guidance issued by Treasury, and determining the appropriate follow-up activities—whether that is providing comments to Treasury in support of proposed regulations, commenting that Treasury should issue additional guidance or take a different approach in final regulations, advocating for legislative changes in the lame duck session, or all of the above. Taxpayers who are submitting comment letters should be mindful that their comment letters will be included in the administrative record, and may provide support for subsequent challenges to the validity of any final regulations.

By: Joshua Odintz and Alexandra Minkovich, Washington, DC

Proposed Regulations Under Section 965

On August 1, 2018, Treasury and the IRS released proposed regulations under section 965. The proposed regulations are the most significant guidance that taxpayers have received on new section 965 to date and generally incorporate most of the prior guidance issued in Notices 2018-07, 2018-13 and 2018-26. In nearly 250 pages of text, this set of rules includes more detailed instructions regarding: how to compute the ultimate liability under section 965, including relevant earnings and profits ("E&P"), deficit and cash position determinations; the calculation of E&P and basis adjustments resulting from the application of section 965 and the treatment of different types of previously taxed income ("PTI"); certain transactions that will be disregarded for anti-avoidance or double counting reasons; the foreign tax credit consequences of the section 965 inclusion itself, as well as the fate of foreign taxes "left behind" due to E&P deficits and those triggered upon distributions of PTI; the mechanics for section 965 liability payments, including the installment payment election; and special rules for affiliated and consolidated groups.

Baker McKenzie will issue a client alert summarizing the main aspects of the proposed regulations and noting our observations on particular points of interest. Any written or electronic comments on the proposed regulations and requests for a public hearing must be received by Treasury before October 9, 2018.

By: Julia Skubis Weber, Chicago

IRS Withdraws 2016 Temporary Regulations Affecting Debt-Financed Distribution Exception to Disguised Sale Treatment

On June 19, 2018, Treasury issued Proposed Treas. Reg. § 1.707-5, which proposes the withdrawal of temporary regulations issued in 2016 (the "2016 Debt-Financed Distribution Temporary Regulations") that required a partnership to treat debt whose proceeds are distributed to a partner in connection with the contribution of property by that partner to the partnership as if such debt were "nonrecourse" for purposes of determining whether the distribution of debt proceeds should be treated as part of a taxable disguised sale or the contributed

property by the partner to the partnership, even if the debt is guaranteed by the partner to which the distribution of debt proceeds is made. This article will first discuss how partnership liabilities are allocated among the partners and give some background on disguised sales and the debt-financed distribution exception from disguised sale treatment. It will then discuss the proposed and temporary regulations issued in 2016 relating to the manner in which partnership liabilities are allocated for various purposes, including the 2016 Debt-Financed Distribution Temporary Regulations. It will finish by discussing the withdrawal of the 2016 Debt-Financed Distribution Temporary Regulations and its impact on taxpayers.

How Are Partnership Liabilities Allocated?

The regulations promulgated under Code Section 752 contain rules for how partnership liabilities are allocated among the partners. A partner's allocable share of partnership liabilities is added to that partner's basis in its partnership interest. Partnership liabilities are generally classified as either "recourse" or "nonrecourse."

A "recourse liability" is a partnership liability for which one or more partners bears the economic risk of loss, generally either because the liability is guaranteed by a partner or because it is owed by the partnership to a partner. In order to determine who bears the economic risk of loss for a partnership liability, the regulations assume that the partnership's assets are worthless and that the partnership therefore cannot repay its liabilities (the "Worthless Asset Assumption"). If any partner would suffer an economic loss with respect to any amount of partnership liabilities (either because the partner is responsible for the repayment of such amount under a guarantee or because the partnership is unable to repay any loans made to it by the partner), that amount is treated as a "recourse liability" with respect to such partner. A "recourse liability" is entirely allocated to the partner who bears the economic risk of loss with respect thereto.

Any partnership liability which is not a "recourse liability" is treated as a "nonrecourse liability." In other words, a "nonrecourse liability" is a partnership liability for which no partner bears the economic risk of loss. Nonrecourse liabilities are allocated among the partners in accordance with the manner in which they share partnership profits.

What is a Disguised Sale?

Generally, contributions of property to a partnership are non-taxable transactions under Code Section 721. Similarly, a distribution of money by a partnership to a partner is also tax-free under Code section 731 if the partner has sufficient basis in its partnership interest to absorb the amount of the distribution. Code Section 707 and the regulations promulgated thereunder provide an anti-abuse rule, pursuant to which a contribution of property by a partner to a partnership and a related distribution of money by the partnership to such partner are treated as a taxable "disguised sale" of the contributed property by the partner to the partnership if the distribution of money by the partnership would not have occurred but for the contribution of the property by the partner. A contribution and distribution that occur within a two years of each other are presumed to be part of

a disguised sale unless the facts and circumstances demonstrate otherwise or an exception applies.

What is the Debt-Financed Distribution Exception?

The disguised sale regulations contain an exception from disguised sale treatment, known as the "debt-financed distribution exception," which provides that, if the partnership borrows money and distributes proceeds of that loan to a partner that contributes property to the partnership, the 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.

Taxpayers used this exception to engage in so-called "leveraged partnership" transactions to avoid immediately recognizing taxable gain on assets they wished to dispose of. In a typical "leveraged partnership" transaction, instead of disposing of property in a taxable sale, the "seller" contributes that property to a partnership with the "buyer," who contributes to the partnership other property intended to be used in the same trade or business as the property contributed by the "seller." The partnership then borrows money, the loan is guaranteed by the "seller" and the loan proceeds are distributed to the "seller," who also receives a small participating preferred interest in the partnership. The projected net cash flow of the partnership is generally expected to be sufficient to satisfy debt service payments on the loan. Because the "seller" guarantees the loan, the loan is treated as a "recourse liability" which is entirely allocated to the "seller." Consequently, none of the loan proceeds distributed to the "seller" are treated as part of a disguised sale of the property contributed by the "seller" to the partnership because they fall within the debt-financed distribution exception. In this manner, the "seller" is able to avoid immediate recognition of taxable gain on the property contributed to the partnership even though it has disposed of most of its economic interest in such property. Taxation is deferred until the loan is repaid by the partnership or the "seller" disposes of its interest in the partnership.

The 2016 Temporary and Proposed Regulations

On October 5, 2016, Treasury issued both proposed and temporary regulations addressing the manner in which partnership liabilities are allocated among the partners. A part of this package restricted the ability of a partner to use guarantees of a partnership liability to allocate the guaranteed amount of the liability to that partner under section 752 for purposes of determining the partner's outside basis in its partnership interest. Temporary regulations (the "2016 Recourse Liability Temporary Regulations") generally ignore so-called "bottom dollar guarantees" as creating economic risk of loss to the guarantor-partner with respect to the guaranteed amount, notwithstanding the Worthless Asset Assumption. A "bottom dollar guarantee" is a guarantee of a partnership liability by a partner that, pursuant to its terms, does not give the creditor the ability to recover from the guarantor-partner starting from the first dollar of any loss incurred by the creditor. Proposed regulations issued contemporaneously (the "2016 Recourse Liability Proposed Regulations") further create an anti-abuse rule under which certain guarantees, even those that are not "bottom dollar guarantees," would not be treated as creating economic risk of loss to the guarantor partner if they evidence a plan to circumvent or avoid the associated

payment obligation. The 2016 Recourse Liability Proposed Regulations include a list of seven non-exclusive factors that the IRS views as evidencing a plan to circumvent or avoid a payment obligation pursuant to a purported guarantee.

As part of the same regulatory package, Treasury also issued the 2016 Debt-Financed Distribution Temporary Regulations. Pursuant to the 2016 Debt-Financed Distribution Temporary Regulations, all partnership liabilities were treated as “nonrecourse” when determining the partners’ allocable share of any partnership debt for purposes of the debt-financed distribution exception from disguised sale treatment, even if such liabilities are “recourse” to a partner for purposes of section 752 and the regulations promulgated thereunder because they are guaranteed by such partner and the guarantee is respected under the 2016 Recourse Liability Temporary Regulations and the 2016 Recourse Liability Proposed Regulations. For purposes of the debt-financed distribution exception, all liabilities were therefore allocated to the partners in accordance with the manner in which they share in partnership profits under the 2016 Debt-Financed Distribution Temporary Regulations.

This severely restricted the ability of taxpayers to engage in leveraged partnership transactions and pull debt proceeds out of a partnership in a tax-free manner in connection with the contribution of property to the partnership. Applied to the leveraged partnership example discussed above, the 2016 Debt-Financed Distribution Temporary Regulations would have caused the partnership debt whose proceeds are distributed to the “seller” partner to be allocated in accordance with the manner in which the partners share in partnership profits for purposes of the debt-financed distribution exception, despite the fact that the “seller” partner guarantees the debt. Because the “seller” partner receives a small participating preferred interest in the partnership, most partnership profits are allocated to the “buyer” partner. This would have meant that only a small fraction of the debt whose proceeds are distributed to the “seller” would have been allocated to the “seller” for purposes of the debt-financed distribution exception despite the guarantee, and, consequently, the majority of the debt proceeds distributed to the “seller” would not have been eligible for the debt-financed distribution exception from disguised sale treatment and would have been treated as proceeds from a taxable sale of the property contributed by the “seller” to the partnership.

The Road to Withdrawal of the 2016 Debt-Financed Distribution Temporary Regulations

In April 2017, President Trump signed Executive Order 13789, 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. In July 2017, the IRS issued Notice 2017-38, which identified eight regulatory packages that Treasury determined met the criteria listed in the executive order. The 2016 Debt-Financed Distribution Temporary Regulations, the 2016 Recourse Liability Temporary Regulations, and the 2016 Recourse Liability Proposed Regulations were all identified in that notice as meriting further scrutiny.

On October 4, 2017, Treasury issued a report that recommended actions to eliminate or mitigate the burdens imposed on taxpayers by the regulations identified in Notice 2017-38. The report intimated that the 2016 Debt-Financed Distribution Proposed Regulation would be revoked and the prior regulations reinstated, because these regulations changed the tax treatment of many partnerships and such a far-reaching change should be studied systematically before new regulations are issued. By contrast, the report stated that the 2016 Recourse Liability Temporary Regulations and the 2016 Recourse Liability Proposed Regulations would be substantially retained in their current form, 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.

Withdrawal of the 2016 Debt-Financed Distribution Temporary Regulations

The proposed regulations issued on June 19, 2018 withdraw the 2016 Debt-Financed Distribution Temporary Regulations and generally reinstate the rules in effect prior to their issuance. Therefore, for purposes of the debt-financed distribution exception to disguised sale treatment, each partner's allocable share of a partnership liability whose proceeds are distributed to partners contributing property to the partnership are generally determined in the same manner as that liability is allocated to the partners under section 752 and the regulations promulgated thereunder. This means that, for purposes of the debt-financed distribution exception, if the loan whose proceeds are distributed is a "recourse liability," it will be allocated to the partner who bears the economic risk of loss with respect to that loan, and, if the liability is "nonrecourse," it will be allocated to the partners in accordance with the manner in which they share in partnership profits. A partnership and its partners may apply the old rules reinstated by the new proposed regulations in lieu of the 2016 Debt-Financed Distribution Temporary Regulations to any transaction with respect to which all transfers occur on or after January 3, 2017.

The withdrawal of the 2016 Debt-Financed Distribution Temporary Regulations has lifted the restrictions imposed on taxpayers who engage in leveraged partnership transactions to pull debt proceeds out of a partnership tax-free in connection with the contribution of property to the partnership if they guarantee the debt whose proceeds are distributed to them. That being said, in order for such a transaction to remain tax-free, a taxpayer's guarantee of the partnership debt whose proceeds are distributed to it must be respected as shifting economic risk of loss to the taxpayer, making the debt "recourse" to such taxpayer under section 752, including under the 2016 Recourse Liability Temporary Regulations and the 2016 Recourse Liability Proposed Regulations, which still remain in effect.

By: Maher Haddad, Chicago

Section 987 Regulations are Further Delayed and Onerous Section 385 Documentation Rules to be Withdrawn

The IRS and Treasury continue to follow-through on their promise to review the eight regulations listed in Notice 2017-38 that cause undue “burdens” on taxpayers. In the last month, the IRS and Treasury have further delayed the effective date of the new section 987 regulations that determine how a taxpayer should translate income earned by foreign branches into the taxpayer’s currency. In addition, it has been reported that the IRS and Treasury have submitted proposed regulations to the OMB that would withdraw the section 385 loan documentation regulations.

Section 987 Delay

In 2016, final section 987 regulations were issued that require taxpayers to follow a very complex method for translating the income of a foreign branch into a taxpayer’s functional currency. These regulations were generally supposed to be effective starting in January of 2018, but the Trump administration has twice delayed these regulations as they continue to review whether the regulations are unnecessarily burdensome under Notice 2017-38. As a result, 2020 is the earliest year that the rules will be effective.

Many taxpayers have requested that the IRS and Treasury modify the section 987 regulations because these regulations represent a complete departure from GAAP principles for translating the income of a foreign branch into a different currency. To comply with the regulations, tax departments will need to implement entirely new procedures and processes to record multiple basis calculations in different currencies for a branch’s assets, including inventory. In response, taxpayers have requested that the IRS and Treasury align the section 987 regulations more closely with GAAP principles and thereby avoid creating undue tax compliance burdens when calculating Section 987 gains and losses.

Until the section 987 regulations become effective in 2020 or are replaced with new regulations, taxpayers can continue using a “reasonable” method to calculate their section 987 gain and loss from foreign branches. However, the loss deferral provisions in the section 987 regulations remain in force.

Withdrawal of the Documentation Rules

The IRS and Treasury have submitted proposed section 385 regulations that are expected to withdraw the loan documentation provision in Section 1.385-2 of the Treasury Regulations. The documentation rules provide that, if a taxpayer’s loan does not contain appropriate legal provisions and economic analyses, then the loan is treated as stock—unless the taxpayer has reasonable cause for failing to properly document the loan. Due to the severe punishment for non-compliance with these rules (i.e., recharacterization of the loan as equity), many taxpayers have criticized the rules as causing undue burdens on taxpayers.

In line with the purpose of Notice 2017-38, it is expected that proposed regulations will reduce the burden on taxpayers by withdrawing the draconian documentation rules. Nevertheless, if a taxpayer anticipates an IRS challenge to an intercompany loan, the taxpayer should consider complying with documentation regulations (even if withdrawn) because a loan satisfying the current documentation regulations is more likely to withstand a debt-equity challenge under common-law tax principles.

It is also not clear what will happen to the "*per se*" stock rules under Section 1.385-3 of the Treasury Regulations. These *per se* rules automatically recharacterize intercompany debt as equity if the debtor makes a distribution or enters into certain prohibited transactions during a six-year period. At the time these *per se* rules were written, the IRS and Treasury were feverishly taking any steps they could to prevent US companies from inverting and engaging in interest stripping transactions. However, given the promulgation of the anti-inversion regulations in section 7874 and the enactment of the interest deduction limitation provisions as part of Tax Reform (i.e., the BEAT, Section 163(j) interest limitations, anti-hybrid rules, etc.), many taxpayers have written to Treasury requesting that the *per se* stock rules be withdrawn. Since these other provisions now adequately address the interest stripping concerns that drove the promulgation of the *per se* stock rules, the enormous complexity and compliance hassle caused by the *per se* stock rules outweigh their marginal benefit to tax administration. Yet, with the *per se* rules still in effect, taxpayers must continue to monitor their intercompany borrowings to ensure that they do not accidently run afoul of the *per se* stock rules.

By: John Barlow, Washington, DC

IRS Issues Final Regulations on Inversions

On July 11, 2018, the Treasury Department and IRS released final regulations relating to corporate inversions (the "Final Regulations"). T.D. 9834 (July 11, 2018). The Final Regulations are largely consistent with temporary and proposed regulations issued in 2016 (the "Temporary Regulations"), though there are a few areas in which the Final Regulations deviate from the Temporary Regulations. Many of the rules contained in the Final Regulations were originally announced in Notice 2014-52 and Notice 2015-79. For a more thorough discussion of the two notices and the initial regulations, please see the Baker McKenzie Client Alert, "*Treasury Issues Temporary Regulations on Inversions*", distributed on May 3, 2016 and also available under insights at www.bakermckenzie.com.

If applicable, Code Section 7874 can cause a resulting foreign parent corporation to be taxable as a domestic corporation (i.e. where there is 80% ownership continuity by the former shareholders) or can cause the inversion transaction to be fully taxable (i.e. where there is 60% ownership continuity). As such, the amount of ownership change in the inverted company is a central requirement for the application of section 7874. The guidance provided in the Final Regulations generally can be divided into two categories. The first category of guidance in the Final Regulations makes it more difficult for companies to successfully complete an inversion without running afoul of section 7874. The second category of guidance limits certain post-inversion tax planning opportunities. New provisions

in the Final Regulations are generally effective as of July 12, 2018; however, taxpayers may elect to apply the updated rules to transactions occurring prior to July 12, 2018. Provisions in the Final Regulations that are consistent with the Temporary Regulations generally retain the same effective date that applied to the Temporary Regulations. These effective dates range from September 22, 2014 (the date on which Notice 2014-52 was released), to November 19, 2015 (the date on which Notice 2015-79 was released), to April 4, 2016 (the date on which the Temporary Regulations were released).

Limitations on the Ability to Invert Under Code Section 7874

Treas. Reg. § 1.7874-7: Passive Asset/ "Cash Box" Rules

For purposes of determining the 60% and 80% stock ownership thresholds that are central criteria for the application of the inversion rules, the Temporary Regulations adopted the passive asset, or "cash box" rules in Notice 2014-52 and Notice 2015-79 to disregard a portion of the stock of a foreign acquiring corporation. These rules apply if more than 50 percent of the foreign group's property constitutes cash, marketable securities and other passive assets that are defined as "foreign group nonqualified property." The Final Regulations generally adopt the rules of the Temporary Regulations, but with several changes.

As opposed to the Temporary Regulations, which disregarded foreign acquiring corporation stock in determining the section 7874 ownership percentage by vote and value, the Final Regulations provide that if foreign acquiring corporation stock is disregarded under the "cash box" rules, it is disregarded only for purposes of determining the ownership percentage by value and not by vote. The preamble states that this is due in part to administrative difficulties in applying the rules where different classes of stock possess different voting rights.

The Final Regulations take into account section 7874(c)(4) and other rules in the Final Regulations (such as the serial acquisitions rule) that disregard stock of the foreign acquiring corporation for purposes of calculating the amount of stock excluded under the "cash box" rules. This prevents an amount of stock that has already been excluded under another rule from being again excluded under the "cash box" rules. Furthermore, the Final Regulations explicitly provide that the "cash box" rules are subject to section 7874(c)(4). The preamble notes that section 7874(c)(4) can apply to disregard the transfer of property or liabilities as part of a plan with a principal purpose to avoid the 50 percent threshold of the "cash box" rules.

Finally, the Temporary Regulations provided an exclusion for certain property that gives rise to income described in sections 1297(b)(2)(A) and (B), relating to certain income derived in the active conduct of a banking or financing business, from the definition "foreign group nonqualified property." The Final Regulations clarify that for purposes of determining the applicability of this exclusion from "foreign group nonqualified property," other exceptions to sections 1297(b)(2)(A) and (B) do not apply.

Treas. Reg. § 1.7874-8: Serial Acquisition Rules

The Temporary Regulations introduced a serial acquisition rule that, in the case of multiple acquisitions of domestic entities by a foreign acquiring corporation within a 36-month period, disregards stock in the foreign acquiring corporation that is attributable to a prior domestic entity acquisition (whether or not factually related). If the rule applies, the denominator in the section 7874 ownership test, by value but not vote, is reduced by an amount of stock attributable to the prior domestic entity acquisition. The Temporary Regulations with respect to the serial acquisition rules were the subject of ongoing litigation in *Chamber of Commerce of the United States v. Internal Revenue Service,* 2017 U.S. Dist. LEXIS 175245 (W.D. Tex. 2017). The primary dispute at issue in the *Chamber of Commerce* case was whether the Temporary Regulations satisfied APA requirements related to notice and comment. Upon publication of the Final Regulations, the Fifth Circuit granted the IRS's motion to dismiss the case from appellate proceedings as moot. Similar to the "cash box" rules, the Final Regulations generally follow the Temporary Regulations.

The Final Regulations state that stock of the foreign acquiring corporation that is deemed issued under either the non-ordinary course distribution rule in Treas. Reg. § 1.7874-10 or section 7874(c)(4) is not taken into account in determining the amount of stock attributable to a prior domestic entity acquisition. The Final Regulations also provide an additional exception to the term "prior domestic entity acquisition." If the prior acquisition of a domestic entity qualified for the internal group restructuring exception of Treas. Reg. § 1.7874-1 within a foreign parented group, it is not considered a prior domestic entity acquisition for purposes of applying the serial acquisition rule. Finally, the Final Regulations cross-reference the definition of "predecessor" in determining whether a foreign acquiring corporation (or its predecessor) have completed prior domestic entity acquisitions to the existing rule in the non-ordinary course distribution rules of Treas. Reg. § 1.7874-10.

Treas. Reg. § 1.7874-9: Third-Country Rule

The Temporary Regulations added the third-country rule originally outlined in Notice 2015-79. Under the Temporary Regulations, if the foreign acquiring corporation acquired either the stock or assets of another foreign corporation (the foreign acquired corporation) in a transaction related to a domestic entity acquisition, and the two foreign corporations are each "subject to tax as a resident" in different jurisdictions, stock of the foreign acquiring corporation held by reason of holding stock in the foreign acquired corporation will be removed from the denominator of the section 7874 ownership fraction. This rule applies only if the ownership fraction was already greater than 60 percent.

The Final Regulations replaced the phrase "subject to tax as a resident" with the phrase "tax resident." "Tax resident" is defined with a reference to Treas. Reg. §1.7874-3(d)(11) (the substantial business activities test), which defines the term as "a body corporate liable to tax under the laws of the country as a resident." The preamble notes that the change was made to address situations where the foreign entity is either resident in a jurisdiction without an income tax or is fiscally transparent.

The Final Regulations also add two exceptions to the application of the third-country rule. First, the third-country rule does not apply if the foreign expanded affiliated group ("EAG") would satisfy the substantial business activities test, applying the principles of Treas. Reg. § 1.7874-3, in the third country in which the foreign acquiring corporation is tax resident. Second, the third-country rule does not apply where, taking into account all related transactions, both the foreign acquiring and foreign acquired corporation are both organized in a jurisdiction without an income tax, and neither foreign corporation is a tax resident of another jurisdiction.

The Final Regulations also contain a new rule that treats a change in the foreign acquiring corporation's tax residency as a foreign acquisition by deeming the foreign acquiring corporation to be both a foreign acquiring and a foreign acquired corporation. The rule creates a fictional transaction whereby the deemed foreign acquiring corporation acquires the assets of the deemed foreign acquired corporation in exchange for stock of the foreign acquiring corporation. This rule has the effect of creating a foreign acquisition for purposes of the third-country rule without a legal acquisition. The preamble notes that this could be the result of a change in the location of management and control (presumably without a corresponding change in legal form or place of organization).

Treas. Reg. § 1.7874-10: Non-Ordinary Course Distributions

The Temporary Regulations also introduced the non-ordinary course distribution ("NOCD") rule, which deems domestic shareholders or partners of the domestic entity to have received additional stock in the foreign acquiring corporation equal to the value of any NOCDs within the look-back period (generally 36 months, separated into three 12-month "look-back years"). The Final Regulations provide a number of changes to the NOCD rule.

The Final Regulations provide that the term "distribution" does not include deemed distributions pursuant to a reduction of liabilities within the scope of Code Section 752(b), provided the deemed distribution does not arise from a transaction that reduces the partnership's value. The term also excludes a distribution of stock pursuant to an acquisitive asset reorganization, but does include a Code Section 355 distribution even if pursuant to a section 368(a)(1)(D) reorganization.

In addition, the Final Regulations modify a rule in the Temporary Regulations that applied where a domestic distributing corporation in a section 355 transaction distributed a domestic controlled corporation that represented more than 50 percent of the value of the distributing corporation; in such a case, the Temporary Regulations deemed the controlled corporation to have distributed the distributing corporation. The Final Regulations modify the rule to measure the 50 percent threshold by including the fair market value of any controlled stock held by a related person (within the meaning of section 7874(d)(3) but including foreign persons).

The Final Regulations clarify the interaction of the NOCD rule and the EAG rules by stating that stock deemed issued under the NOCD rule is not taken into account in applying the EAG rules, which are applied with respect only to stock

that actually exists. However, the Final Regulations note that NOCD stock is generally included in both the numerator and denominator of the section 7874 ownership fraction, except as excluded under the EAG rules.

In determining how to allocate the stock deemed to be issued as a result of the NOCD rule, the Final Regulations treat a pro rata portion (comparing the NOCDs during the look-back year with the total amount of all distributions during the look-back year) of each distribution as subject to the NOCD rule.

The Final Regulations also provide that if two or more foreign acquiring corporations complete a domestic entity acquisition, the stock deemed issued under the NOCD rule is deemed issued by each foreign acquiring corporation that directly or indirectly provided consideration (eg, a triangular acquisition). Similarly, if a foreign acquiring corporation acquires two or more domestic entities that are treated as a single domestic entity under Treas. Reg. § 1.7874-2(e), the NOCD rule is applied to each domestic entity individually and then the sum total of NOCDs is treated as the amount of NOCDs for the combined domestic entity.

Treas. Reg. § 1.7874-4, -7, -10: De Minimis Exceptions

The disqualified stock rule of Treas. Reg. § 1.7874-4(b), the passive assets rule, and the NOCD rule all provided for *de minimis* exceptions to their application when (i) the ownership percentage (disregarding the application of these rules) is less than 5 percent, and (ii) each former domestic entity shareholder or partner owns less than 5 percent of the stock of each member of the EAG (after application of attribution rules). The Final Regulations modify these rules with respect to the second requirement and only apply the rules to former domestic entity shareholders or partners that held 5 percent or more (by vote and value) of the domestic entity.

Treas. Reg. § 1.7874-1: EAG Coordination Rules

The Final Regulations provide an updated coordination rule to provide that stock of the foreign acquiring corporation that is disregarded (for purposes of determining the ownership fraction) under any of the relevant rules (i.e., the disregarded stock rule, the passive assets rule, the serial acquisition rule, and the third-country rule), as well as stock disregarded under section 7874(c)(4), is nevertheless taken into account for purposes of applying the EAG rules (i.e., considering all stock that actually exists, unlike stock deemed issued under the NOCD rule).

Treas. Reg. § 1.7874-3: Substantial Business Activities Test

As discussed with respect to the third-country rule above, the Final Regulations modify the tax residency requirement for purposes of both the substantial business activities test as well as the third-country rule.

Limitations on Post-Inversion Tax Planning Opportunities

Section 956: Expanding Definition of "United States Property" to Counter Post-Inversion Cash Deployment

Before Notice 2014-52 and the Temporary Regulations, foreign subsidiaries of an inverted US parent could generally loan cash to the inverted group's new foreign parent company without incurring US tax liability. Code Section 956 generally would not apply because the obligor on the loan was not a US person, and therefore the loan was not "United States property." The Temporary Regulations targeted this strategy by expanding the definition of United States property to include certain stock or obligations issued by non-CFC foreign members of an inverted group.

The Final Regulations adopt the concepts set forth in the Temporary Regulations but modify the terminology and nomenclature of the operative rules in acknowledgment of legislative changes made by Congress in recent tax reform legislation—"An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. 115-97 (the "TCJA"). Historically, section 958(b)(4) prevented the "downwards attribution" rule of section 318(a)(3) from causing a foreign corporation to be a CFC when it is neither directly nor indirectly owned by any US person. As part of the TCJA, Congress repealed section 958(b)(4) and thereby greatly expanded the circumstances in which a foreign corporation is a CFC.

Under the Final Regulations, "United States property" includes an obligation of a foreign person and stock of a foreign corporation if three conditions are satisfied. First, the obligation or stock must be held by an expatriated foreign subsidiary (an "EFS"), which is generally defined as any foreign corporation that was a CFC of the former US parent before an inversion that is subject to section 7874 (i.e., EFS status exists only if the inversion fails the "substantial business activities" test and the ownership fraction is between 60% and 80%). When testing CFC status for this purpose, the Final Regulations reinstate the proscription on "downwards attribution" formerly contained in section 958(b)(4). Second, the foreign person that issued the obligation or stock cannot be an EFS and must be related to the holder. Third, the obligation or stock must be acquired during the 10-year period after the inversion or in a transaction related to the inversion.

Section 956: Short-Term Loan Exception

The Temporary Regulations set forth two exceptions from section 956 for short-term obligations. The first exception applied to obligations that are collected within 30 days from the time the obligation is incurred, so long as the relevant CFC does not have loans to related US persons that would constitute United States property outstanding during the relevant tax year for more than 60 days (the "30/60 Exception"). The second exception was identical to the first, except that (i) it extended the 30 and 60 day time periods to, respectively, 60 and 180 days; and (ii) it was only available with respect to certain pre-2011 tax years (the "60/180 Exception").

The Final Regulations adopt the 30/60 Exception but do not adopt the 60/180 Exception.

Treas. Reg. § 1.7701(l)-4: Recharacterization Rule to Counter De-Control Transactions

The Temporary Regulations provided a rule in Treas. Reg. § 1.7701(*l*)-4T that was intended to discourage "de-control" transactions pursuant to which the foreign parent of an inverted group or one of its non-CFC foreign affiliates would acquire stock in an EFS to dilute its US ownership and potentially cause it to lose CFC status. The Final Regulations generally follow the Temporary Regulations but modify the terminology and nomenclature of the operative rules for reasons similar to those discussed above in connection with section 956.

Under the Final Regulations, Treas. Reg. § 1.7701(*l*)-4 applies to "specified transactions." A specified transaction generally occurs if stock of an EFS is issued or transferred to a non-EFS foreign affiliate during the 10-year period following an inversion. A specified transaction is recharacterized as though (i) the non-EFS foreign affiliate transferred the property to certain US shareholders of the EFS in exchange for newly-issued equity in the applicable US shareholders, and (ii) the applicable US shareholders contributed the property down the chain of ownership to the EFS (if the underlying transaction involved an issuance of EFS shares) or to the EFS's shareholder (if the underlying transaction involved a transfer of EFS shares).

Treas. Reg. § 1.367(b)-4(e) and (f): Stock and Asset Dilution Rules

The Temporary Regulations contained rules in Treas. Reg. § 1.367(b)-4T(e) and (f) that were intended to operate in tandem with Treas. Reg. § 1.7701(*l*)-4T to combat post-inversion transactions that dilute the interest of a US shareholder in a CFC. The Final Regulations adopt the concepts set forth in the Temporary Regulations but modify the terminology and nomenclature of the operative rules for reasons similar to those discussed above in connection with section 956.

Under the Final Regulations, Treas. Reg. § 1.367(b)-4(e) applies if a foreign corporation acquires—in a "specified exchange"—stock in a foreign corporation in a Code Section 351 exchange or stock or assets of a foreign corporation in a Code Section 368 reorganization. An exchange generally is a specified exchange if (i) immediately before the exchange, the foreign acquired corporation is an EFS and the exchanging shareholder is either an EFS or an inverted US corporation, (ii) the stock received in the exchange is stock of a foreign corporation, and (iii) the exchange occurs during the 10-year period following the inversion. If Treas. Reg. § 1.367(b)-4(e) applies, the exchanging shareholder must include in income as a deemed dividend the "section 1248 amount" attributable to the stock it exchanges and recognize all realized gain with respect to the exchanged stock that would otherwise not be recognized. Treas. Reg. § 1.367(b)-4(f) applies if an EFS transfers property (other than stock in another EFS) to a foreign corporation in a section 351 exchange within the 10-year period following an inversion. If Treas. Reg. § 1.367(b)-4(f) applies, the EFS must recognize all realized gain with respect to the transferred property that would otherwise not be recognized. There are de minimis exceptions to each of Treas. Reg. §§ 1.367(b)-4(e) and (f).

Treas. Reg. § 1.304-7: Application of Section 304(b)(5)(B)

A transaction that is subject to Code Section 304 is generally treated first as a dividend to the extent of the acquiring corporation's earnings and profits ("E&P") and then as a dividend to the extent of the target corporation's E&P. Section 304(b)(5)(B) limits the extent to which a section 304 transaction can be sourced from a foreign acquiring corporation's E&P. Specifically, a foreign acquiring corporation's E&P are only taken into account if more than 50% of the deemed dividend resulting from the section 304 transaction would (i) be subject to US federal income tax or (ii) be included in the earnings and profits of a CFC. The Temporary Regulations clarified in Treas. Reg. § 1.304-7T that this test is applied only by reference to the deemed dividend sourced from the foreign acquiring corporation's E&P (and not from any deemed dividend sourced from the target corporation's earnings and profits).

The Final Regulations adopt the Temporary Regulations. Notably, the Final Regulations also provide that CFC status shall be determined for section 304(b)(5)(B) purposes without applying section 318(a)(3) "downwards attribution" to cause a US person to own stock that is owned by a foreign person. In other words, the Final Regulations purport to override the TCJA's repeal of section 958(b)(4) for purposes of applying section 304(b)(5)(B).

By: Patrick Renckly and Ross Staine, Houston

OECD Releases Final Guidance on Key Topics of BEPS Actions 8 to 10

On June 21, 2018, the Organisation for Economic Co-operation and Development (the "OECD") released two new reports under the inclusive framework on Base Erosion and Profit Shifting ("BEPS") Actions 8-10, specifically titled "Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles" ("HTVI Guidance") and "Revised Guidance on the Application of the Transactional Profit Split Method" ("Profit Split Guidance"). In this article, we summarize the new guidance and discuss interpretations and takeaways for each.

Summary of the Released Guidance

HTVI Guidance

The HTVI Guidance directs tax authorities on how to apply the guidance on the HTVI approach found in Chapter VI of the 2017 OECD Transfer Pricing Guidelines (the "TPG"), and in particular how to consider whether a potential adjustment may arise from the application of the HTVI approach. The HTVI approach was proposed to provide assistance to tax authorities evaluating the transfers of HTVI, and provides that the tax authorities may consider *ex post* financial outcomes of the transfers when determining the appropriateness of *ex ante* pricing agreements. The new HTVI Guidance has been incorporated into the TPG as an annex to Chapter VI, and is meant to improve consistency in

application of the HTVI approach and reduce the risk of double taxation. The 2018 HTVI Guidance contains the following points in particular:

- Describes the principles that should underpin the application by tax authorities of the HTVI approach, with particular emphasis on the use of *ex post* results as presumptive evidence of the reasonableness of *ex ante* pricing arrangements, to prevent negative effects of information asymmetry;
- Provides two examples that illustrate the adjustments that may result from the application of the HTVI approach; and
- Discusses the interaction between the HTVI approach and dispute prevention and resolution approaches.

Profit Split Guidance

The Profit Split Guidance updates Section C of Part III, Chapter II of the TPG by revising and expanding the guidance on the application of the transactional profit split method, and demonstrating the methods to determine the relevant profits to be split, including profit splitting factors. In particular, this revised guidance:

- Emphasizes the importance of applying a most appropriate method analysis before applying a transactional profit split;
- Continues to highlight the importance of accurately delineating transactions;
- Further clarifies the approaches to splitting profits: contribution analysis and residual analysis;
- Elaborates on the application of the profit split, including: (i) actual profits vs anticipated profits, (ii), different measures of profits, and (iii) profit-splitting factors; and
- Provides 16 examples that illustrate the application of the transactional profit split method.

Interpretation and Takeaways from 2018 Guidance on the Application of the HTVI Approach

In authorizing tax authorities to use *ex post* results as presumptive evidence in assessing the arm's length nature of the transaction that was determined *ex ante*, the guidance is essentially giving them the use of hindsight under the guise of accounting for information asymmetry between tax authorities and taxpayers. This may seem counter to the notion of the arm's length standard, although it is not dissimilar to the commensurate with income concept found in the US regulations.

There are some positive points for taxpayers in this guidance as well, as it reiterates from Chapter VI some guardrails that may be helpful for taxpayers:

- Revaluation to determine whether an adjustment is warranted due to *ex post* results should not use those actual results, but should be a modification of the original valuation to appropriately account for the possibility of what turned out to be the actual results;
- If the revaluation leads to a result that is within 20% of the original amount, no adjustment should be made; and
- If outside the 20% band, taxpayers can also avoid adjustment if they can demonstrate that 1) the original arrangement did account for such a result (perhaps with probability-weighted variations) or 2) the taxpayer could not have foreseen such a result.

This guidance certainly points to the need for taxpayers to be diligent in preparing valuations that involve or could be perceived as involving HTVI. Contemporaneous documentation should be prepared to record the potential future outcomes that have been considered and how those outcomes impact the valuation results. Thoughtful consideration must be made of the assumptions and parameters used, as this is likely to receive detailed scrutiny later if a tax authority is to assess whether an *ex post* valuation exceeds the 20% band. There will likely be challenges on discount rates, useful life, use of probability-weighted variations, etc.

The guidance also refers to paragraph 6.193 in the TPG, stating that a transaction would be exempt from potential adjustments under the HTVI approach if it is covered by an agreed bilateral or multilateral advance pricing arrangement ("APA"). This makes sense, given that APAs already serve the purpose of avoiding double-taxation. However, this guidance could lead to the use of the 20% band as a clause within the APA for potential adjustments during or at the end of the term of the APA.

Interpretation and Takeaways from 2018 Guidance on the Application of the Transactional Profit Split Method

When the first draft of the transactional profit split guidance was released in September 2017, taxpayers were concerned that this guidance gave tax authorities too much latitude to reject common one-sided methods and apply transactional profit splits during audit. The draft guidance questioned taxpayers on relatively subjective points such as whether: parties were making unique or valuable contributions; an arrangement was properly delineated; and the benchmarking data was reliable in the first instance. In general, the new Profit Split Guidance addresses some of these concerns and gives taxpayers a few means to rebut spurious applications of the transactional profit split method, but ultimately, it does not change the fact that taxpayers have a greater burden to prove out their pricing approaches in advance.

Since that initial draft, the Profit Split Guidance now includes new language that strengthens the importance of applying a most appropriate method analysis, and,

in paragraph 2.123, elaborates on the difficulties in making judgments to arrive at reasonable parameters. Additionally, paragraph 2.161 was strengthened to emphasize that the transactional profit split method should be prospective, rather than applied in hindsight. However, the accurate delineation of a transaction pursuant to the TPG remains a key point for all taxpayers under the Profit Split Guidance. For example, paragraph 2.116, refers back to Chapter I of the TPG on the steps needed to appropriately delineate transactions. Unlike the IRS, which generally abides by the transactions as defined in a taxpayer's intercompany agreements, intercompany agreements are merely one input into an evaluation process under Chapter I, paragraph 1.36 of the TPG. A tax authority could still apply a transactional profit split if it is indeed the most appropriate method, but it may be more difficult if the intercompany transaction was accurately delineated at the onset. This implies that a proactive delineation of the transaction, accurately applied, and the application of a strong appropriate method analysis, could reduce a taxpayer's exposure from an inappropriate application of the method.

On balance, even with good support, taxpayers will likely be subject to more challenges and adjustments under the new guidance. The subjectivity surrounding the application of the transactional profit split could cost taxpayers more to achieve resolution, even assuming that the facts and circumstances ultimately support the taxpayer's position. This increase in potential double-taxation is no different than what many practitioners have been saying for years. However, it is clear that a lack of advanced diligence for transactions involving intangibles, unique contributions, or complex arrangements, face a cost in the form of the adjustments, either under the transactional profit split, or the HTVI Guidelines.

Fundamentally, taxpayers need ask themselves two questions:

- **First, have I thought through my transactions, and the related parties involved in them, from a holistic risk-assessment perspective?** If not, what is my exposure now? Do I have an accurately delineated transaction such that I face a one-sided method, or a two-sided method from a risk-assessment under the TPG? Is there an intangible involved that requires me to consider the HTVI Guidance? Is my transaction sufficiently complex or involving contributions that requires me to consider the Profit Split Guidance?

- **Second, have I taken a sufficiently broad OECD audit exposure perspective in my documentation efforts?** If not, have I taken a local-country documentation position that undermines my global tax structure? Have I sufficiently documented my pricing position, and is my global transfer pricing policy ready for audit? Can I respond strategically on my key TP transactions when I receive notification of a local audit?

Practically speaking, the new language points to several steps that taxpayers should take to minimize exposures from the transactional profit split method:

- First, proactively conduct a review of your intercompany transactions to understand and accurately delineate the nature of the business

operations, risks, and contributions at play (paragraphs 2.135-2.138 of the TPG);

- Second, appropriately document your transactions. This evidence of accurate delineation, through transaction flows, legal agreements, informational returns, and/or TP documentation or dispute prevention mechanisms can be important to create defensible support for your tax positions; and

- Third, enhance your most appropriate method analyses. This means evaluating your transactions, methods, and comparables in a light of this new OECD-style analysis, and reconsidering your reserves in this light.

If you have transactions involving intangibles, contributions that could be deemed as valuable or unique, or those that are complex, future disputes will require you to be more proactive, diligent, and strategic than ever before.

By: Shane Koball (New York), Gene Tien (Palo Alto) and Katherine Yang (Washington, DC)

Beware of New EU Reporting Obligations Ahead: EU Adopts Directive on Mandatory Disclosure of Cross-Border Tax Arrangements (Covering Arrangements as of June 25, 2018)

On May 25, 2018, the Council of the European Union (EU) adopted a Directive on the mandatory disclosure and exchange of cross-border tax arrangements. *See* Council Directive (EU) 2018/822 of May 25, 2018 (amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements). This is the sixth update of the Directive on Administrative Cooperation and therefore referred to as DAC6. Under the new rules of DAC6, EU based intermediaries such as tax advisors, accountants and lawyers that design or promote reportable cross-border arrangements are required to report potentially aggressive tax arrangements to the tax authorities. Given the broad scope of definitions in the Directive, the reportable arrangements may include arrangements that do not necessarily have a main benefit of obtaining a tax advantage. In addition, while the reporting obligation in principle lies with the EU intermediary advisor, it shifts to the taxpayer in specific cases including situations whereby the intermediary involved is based outside of the EU (e.g. in the US). Below we address the most important aspects of the this new reporting obligation.

What is Covered by Mandatory Disclosure Under DAC6 (or “the Directive”)?

Intermediaries based in the EU will be obliged to submit information on reportable cross-border arrangements with their national tax authorities. Under the Directive a “reportable cross-border arrangement” refers to any cross-border tax planning arrangement which bears one or more of the hallmarks listed in the

Directive and concerns at least one EU Member State. The hallmarks are broadly scoped and represent certain typical features of tax planning arrangements which, according to the Directive, potentially indicate tax avoidance or abuse of direct taxes (e.g., income taxes). Certain arrangements (e.g., those that fall within the specific transfer pricing hallmark) will need to be reported even if they do not satisfy the "main benefit" (of obtaining a tax advantage) test. These include arrangements that involve hard-to-value intangibles or an intra-group cross-border transfer of functions, risks or assets.

Hallmarks

Main Benefit Test: "The main benefit or one of the main benefits of the tax scheme is to obtain a tax benefit."

Hallmarks Main Benefit Test		Hallmarks AEOI and BO
Generic	**Specific**	Schemes which may undermine automatic exchange of information
Confidentiality clause included in transaction	Certain tax loss arrangements	Schemes involving non-transparent legal or beneficial ownership chain
Fee structure reflects tax advantage	Conversion of income types which benefit from lower taxation or exemption	
Standardized tax arrangements available to more than one taxpayer	Circular transactions without primary commercial function	

Hallmarks Cross-border Transactions		Hallmarks Transfer Pricing
Depreciation on same asset in multiple jurisdictions	Tax-deductible payment to an associated enterprise (AE) resident in a jurisdiction with no/almost zero CIT	Use of unilateral safe harbour rules
Multiple relief from double taxation	Tax-deductible payment to AE resident in an EU/OECD-blacklisted jurisdiction	Transfer of hard-to value intangibles
Cross-border mismatch asset transfer	Tax-deductible payment to AE resident in a jurisdiction where the payment is fully exempt	Intragroup cross-border transfer of functions and/or risks and/or assets, subject to the EBIT of the transferor(s)
Tax-deductible payment to an associated enterprise with no tax residency	Tax-deductible payment to AE resident in a jurisdiction where the payment benefits from a preferential tax regime	

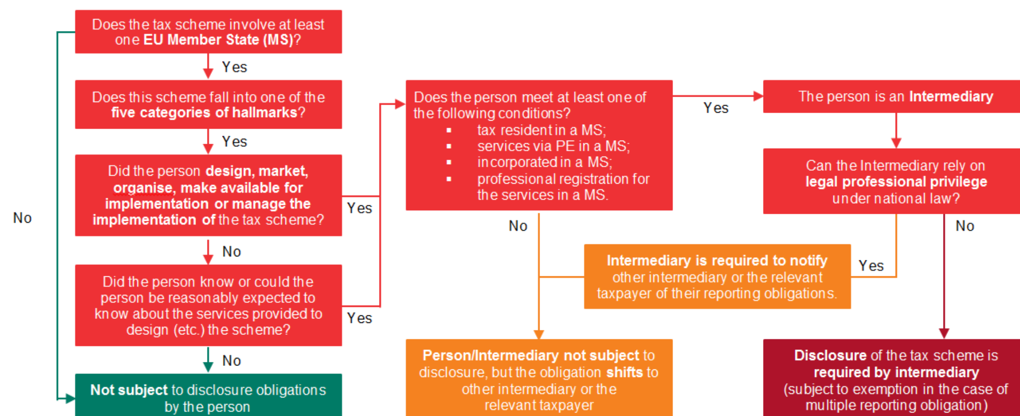
Require the main benefit-test to be fulfilled

Require no main benefit-test to be fulfilled

Under the Directive an 'intermediary' refers to any person that designs, markets, organizes, makes available for implementation or manages the implementation of a reportable cross-border arrangement. Additionally, it also means any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows, or could be reasonably expected to know, that they have undertaken to provide aid, assistance or advice with respect to a reportable cross-border arrangement. In practice, intermediaries include lawyers, accountants, tax and financial advisors, banks and consultants. If the intermediary is not located in the EU or is bound by professional privilege or secrecy rules, the obligation to report shifts from the intermediary to the relevant taxpayer. Information with regard to reported arrangements will be automatically exchanged by the competent authority of each EU Member State every 3 months through the use of a secure central directory on administrative cooperation in the field of direct taxation. Also known as the common communication network (CCN) developed by the European Union. The information exchange will contain details such as the identification of intermediaries and relevant taxpayers, details on the relevant hallmarks and national provisions, details on the first step of

implementation, details on the value of the reportable cross-border arrangement and identification of Member States that are affected or likely to be concerned by the reportable arrangement.

Reporting Obligations Flowchart

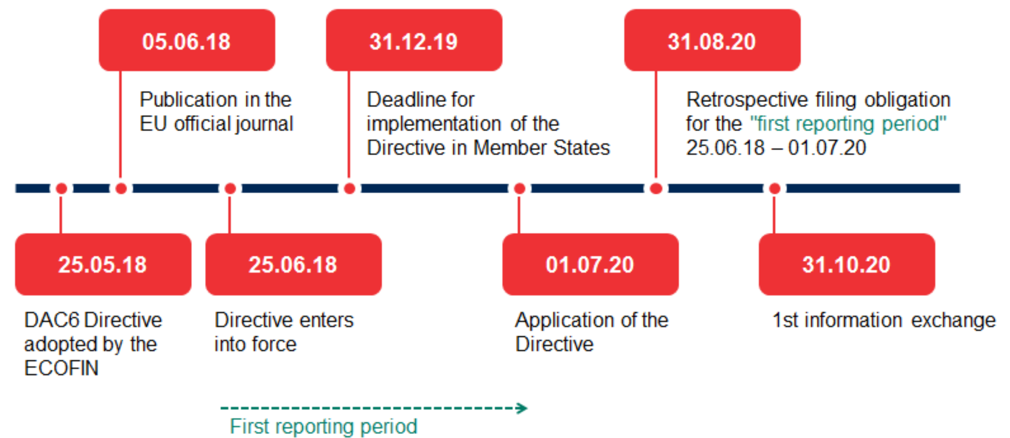


Non-compliance (by intermediaries or taxpayers) with reporting requirements will attract penalties as will be established in the national legislation of the respective EU Member State. The Directive prescribes that these penalties must be “effective, proportionate and dissuasive”. The Directive also states that the fact that a tax authority does not react to a reportable cross-border arrangement does not imply any acceptance of the validity or tax treatment of that arrangement.

When do the New Rules on Mandatory Disclosure Start to Apply?

EU Member States are required to transpose the Directive into national legislation by December 31, 2019 and apply the new rules from July 1, 2020. However, the Directive and thus the reporting obligation applies to transactions implemented as from June 25, 2018. Intermediaries and relevant taxpayers are obliged to file information for the first time by August 31, 2020 with respect to reportable transactions implemented between June 25, 2018 and July 1, 2020 (“first reporting period”). This means that records of any potentially reportable arrangements that have occurred from June 25, 2018 onwards should be kept. Subsequently, the first “regular” information exchange between EU Member States will have to take place by October 31, 2020.

Timeline



Following the first reporting period, information on reportable cross-border arrangements must be filed with the relevant tax authority every time within 30 days beginning on the day after the reportable cross-border arrangement is made available for implementation, is ready for implementation or when the first step has been implemented, whichever occurs first.

What Does it Mean for you as the Taxpayer?

When you instruct an intermediary in the EU in an engagement which qualifies as a “reportable cross-border arrangement”, the intermediary will, in principle, be required to report the arrangement to the respective national tax authority. If the intermediary is legally qualified and professional privilege applies (which is to be determined by the Member States upon implementation of the Directive), or if you instruct an intermediary situated outside of the EU, the reporting obligation will shift to you and you will be responsible for complying with the reporting obligations. We note that according to the Directive in this scenario the intermediary will have the right to a waiver (to be granted by you) of privilege to enable it to make the report. It remains to be seen how EU Member States will implement these rules in their domestic legislation as we expect different rules given the options provided by the Directive to Member States.

What Does it Mean for Intermediaries?

When you engage multiple intermediaries, the reporting obligation in principle lies with all intermediaries involved in the same arrangement, however an intermediary can be exempt from reporting to the extent that it has proof that a report of the arrangement has been filed by another intermediary. When we are your intermediary, we will assess each individual arrangement and inform you on our or your (potential) reporting obligations. Each time we will outline the scope of the relevant reporting obligations to you and, where applicable, support you in complying with your reporting obligations.

By: Mounia Benabdallah, New York

Taxpayer's Deduction of Payment to Russian Subsidiary Denied As Bad Debt and Business Expense

A district court denied the deductibility of a taxpayer's payment of $52 million to a Russian subsidiary to avoid the subsidiary's liquidation. *See Baker Hughes Inc. v. United States*, No. 4:15-CV-2675 (S.D. Tex. 2018). The payment was ineligible for treatment as a bad debt deduction under Code Section 166 or an ordinary and necessary trade or business expense under Code Section 162.

Facts

The taxpayer ("US Parent") was the parent of an affiliated group that conducted fracking operations in Russia indirectly through a Russian subsidiary ("Russia Sub"). Russia Sub entered a contract with a third party to perform services in Siberian oil fields, which included a performance guarantee by US Parent under which the third party could demand US Parent to perform the contract and to be liable for any losses, damages, or expenses, in the event Russia Sub failed to complete the contract.

Russia Sub ultimately sustained losses as a result of the contract. Thereafter, the Russian Ministry of Finance notified Russia Sub that it was in violation of rules requiring Russia Sub to maintain net assets in an amount at least equal to its chartered capital, and that it was in danger of forced liquidation. US Parent believed that if Russia Sub was liquidated, US Parent would be forced to complete the work under the performance guarantee at a cost that could exceed $160 million. US Parent also was concerned about the potential for reputational damage if its subsidiary were to default.

To prevent the liquidation, US Parent transferred $52 million (on behalf of the Cypriot shareholder) to Russia Sub pursuant to an agreement to provide "free financial aid," which it did "not expect the company to return . . . to the shareholder." US Parent claimed a deduction of $52 million on its tax return, which was disallowed by the IRS. US Parent contended that the payment was deductible as bad debt under section 166 or as an ordinary and necessary trade or business expense under section 162.

Court's Analysis

First, US Parent argued that the payment was deductible because it was a discharge of its obligation to guarantee performance on the services contract, which should be treated as a business debt that became worthless in the taxable year it was paid.

Section 166 allows a deduction for debt that becomes worthless; however, the regulations state that capital contributions are not considered debt for such purposes. Thus, the court performed a debt-equity analysis (citing to the multi-factor debt-equity test), finding that the payment was clearly debt and not equity. There was no note evidencing the loan, no expectation for repayment, and no

way to enforce repayment. Further, the relevant agreement specified that the payment was "free financial aid," which would not be repaid. The court stated that, as a practical matter, the payment could not have been a loan because it would not have resolved Russia Sub's net asset and undercapitalization issue.

US Parent also argued that the payment was made pursuant to the performance guarantee, because if Russia Sub was liquidated, US Parent would be liable for damages caused by the breach of contract. The court found the argument unpersuasive because Russia Sub never failed to perform its obligations under the services contract, and the service recipient never sought to enforce the performance guarantee. Thus, the payment did not extinguish US Parent's legal obligation to guarantee performance, nor did it reduce any damages in the event of a default. Instead, the court found that the event triggering the payment was the notice from the Russian Ministry of Finance that Russia Sub was undercapitalized and at risk of forced liquidation.

The court held that the payment to Russia Sub did not create a debt, did not pay a debt, and was not a payment of debt pursuant to a guarantee; therefore, the payment was not deductible under section 166 as a bad debt.

Second, in the alternative, US Parent argued that the payment was a deductible ordinary and necessary business expense because the payment fulfilled US Parent's legal obligations under the performance guarantee and avoided the negative consequences that would have occurred had Russia Sub breached the contract, which included significant monetary damages, the loss of Russia Sub's assets, and reputational damage.

Section 162 allows the deduction of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The court agreed with the IRS that, as a matter of law, the payment was neither an expense nor was it ordinary. The court found that the payment bore none of the hallmarks of an expense because it was a voluntary payment to avoid potential monetary damages, there was no obligation of repayment, and Russia Sub was not restricted in its use of the funds. Instead, the circumstances fit squarely within capitalization principles under both Code Section 263 and Supreme Court precedent.

Further, the court looked at the timing of US Parent's realization of the benefits associated with the payment, which were preventing both the loss of Russia Sub's assets and reputational damage. The court found that such benefits were not realized solely in the year of the payment, and instead were expected to (and presumably did) continue into the future, like any normal capital expenditure. US Parent argued that the future benefit did not preclude a current expense deduction, relying on the *Lohrke v. Commissioner*, 48 T.C. 679 (1967) business reputation line of cases that provide a general exception to the rule that a taxpayer may not deduct the expenses of another. The court declined to apply *Lohrke* finding that the payment was untethered to any actual expense of Russia Sub.

The court held that the payment was not an ordinary and necessary business expense of US Parent under section 162.

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Conclusion

This decision evidences the important role documentation plays in establishing taxpayer intent in characterizing payments in a debt-equity analysis. Furthermore, as demonstrated here, a guarantee payment cannot satisfy a guarantee prior to the guarantee itself being invoked, and such payment will not be deductible as a bad debt or a business expense.

By: Kent Stackhouse, Amsterdam

Clear Intent Still Won't Dictate Deductibility for Settlement Agreement Amounts

The IRS Office of Chief Counsel recently concluded in a partially redacted legal memorandum that the language of a settlement agreement was not controlling when determining the deductibility of settlement payments. ILM 201825027. The IRS stated that the taxpayer has the burden of establishing that the payments were compensatory and thus deductible.

Summary of Facts

In Year 1, two subsidiaries made payments to settle lawsuits for alleged violation of statutes. The lawsuits were filed against the subsidiaries and demanded a "kitchen-sink" assortment of relief and damages, including civil penalties, injunctive relief, attorneys' fees, litigation costs, an accounting, disgorgement, restitution, interest, and treble damages. The subsidiaries entered into a settlement agreement that covered all claims alleged against the subsidiaries. There was no admission of violation of law. The settlement agreement specifically provided that the payments were compensatory and thus deductible for federal income tax purposes. Parent sought to deduct the total amount paid to settle the lawsuits under Code Section 162(a). The IRS disagreed.

Application of Section 162

Under section 162(a), the taxpayers are allowed a deduction for ordinary and necessary expenses in carrying out a trade or business. This rule is limited by section 162(f), which disallows deductions for "fines, penalties, and other amounts" that are "imposed for purposes of enforcing the law and as punishment for the violation thereof." *See also Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497, 652 (1980). In other words, the taxpayers generally are not allowed to break the law, make a payment for breaking the law, and then deduct the payment. On the other hand, the taxpayers may generally deduct restitution payments. Restitution payments are generally deemed to be deductible because they return the parties to their position before the claim. Such payments are different in nature from payments that punish or deter.

The rules introduced by the 2017 Tax Cuts and Jobs Act (P.L. 115-97) now also provide in section 162(f)(2) that the taxpayers must meet three requirements before deducting an amount paid to a government: (i) the amount must constitute restitution for damages or harm caused by the violation or potential violation of law or is paid to come into compliance with the law; (ii) the court or settlement

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agreement must identify the amount as such; and (iii) the amount of restitution for a failure to pay tax must be treated as if it would have been allowed as a deduction, had it been paid. Generally, for purposes of section 162(f), the characterization of a payment depends on the origin of the claim rather than the use of the amount received, and the burden is on the taxpayer to establish that the amounts are compensatory and thus deductible.

In the case considered in the Chief Counsel memorandum, the taxpayer argued that the parties intended for the settlement amounts to be compensatory and that the settlement agreement contained the required language. However, the IRS stated that the lawsuits were based on statutes that contained both punitive and compensatory relief. For instance, restitution is generally compensatory, and civil penalties are punitive, while disgorgement can be either compensatory or punitive. The settlement agreement, the IRS argued, did not break out or substantiate the amounts for compensatory and punitive remedies, and it was the taxpayer's burden to substantiate what amounts were compensatory.

Takeaways

The taxpayers are well-advised to avoid situations where they must determine whether a fine or a penalty paid to a government is deductible. If, however, a taxpayer finds itself going through the nuances of section 162(f), it is critical to remember that facts will win cases. Self-serving language in a settlement agreement that "everything is deductible" will not work. Establishing the facts, before they occur, should be the key. When several violations potentially overlap, negotiate towards restitution damages. A higher before-tax amount in deductible restitution damages may result in a lower-after tax amount when compared to non-deductible penalties and fines.

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