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Legislative and Regulatory Update: Should We Brace Ourselves For a Busy August?

August is traditionally a quiet time for Washington, DC residents--Congress goes on recess for most of the month and government employees and other Washington residents take the opportunity to escape DC's muggy summers for vacations in more temperate locales. But, like so many other things in summer 2020, Washingtonians' usual August plans may be disrupted.

On the legislative front, Congress returned on July 20th from its recess and began negotiating the next round of COVID-19-related legislation. As readers may recall, the House of Representatives has already passed the HEROES Act, which contains some tax proposals (including expanding the employee retention credit, which we believe has bipartisan support). Senate Majority Leader Mitch McConnell (R-KY) has repeatedly said that the Senate will not vote on the HEROES Act, but Senate Republicans are currently working on their preferred legislative proposals. Although we do not expect tax to be the primary focus of the next bill, it is likely that some tax provisions will be included. The timeline for when the Senate Republicans' draft bill will be released continues to shift, but could be as soon as the end of this week (week of July 20th). Once the Republicans release a draft bill, the legislative process is still undecided--will Congress follow regular order, with mark-ups in committee? Will amendments be permitted? Or will be the bill be negotiated by Congressional leadership and presented to Congress for an up-or-down vote, as the CARES Act was? It's also not clear when a bill will be passed--while Democrats generally believe that Congress must pass the next COVID-19-related bill before Congress leaves for its August recess, that view is not universally shared by Republicans.

We anticipate the following tax provisions will be included in the Republican bill: improvements to the Employee Retention Credit, additional stimulus payments to individuals (checks and direct payments), and the return of section 108(i) (delayed payment of tax on cancellation of debt income). Congress is concerned that businesses will face a liquidity crisis, and Republicans may include other items to help businesses efficiently work out existing loans. It is unclear whether Congress will provide for the monetization of general business credits, a proposal that is under active consideration.

All is not quiet on the regulatory front, either. Treasury and IRS released final regulations implementing the deduction for Foreign-Derived Intangible Income ("FDII") and Global Intangible Low-Taxed Income ("GILTI") recently (Baker McKenzie's detailed client alert is forthcoming), and additional regulations are expected soon. As we have previously reported, Treasury's goal is to finalize all Tax Cuts and Jobs Act ("TCJA") regulations by October 2020. Other guidance

Upcoming Tax Events

SALT Savvy

Coast-to-Coast SALT Updates
►August 5, 2020

Recovery & Renewal Webinar Series

Tax Policy
►August 4, 2020

Tax Dispute Resolution
►September 1, 2020

Financial Institutions
►September 15, 2020

Consumer Goods & Retail
►September 29, 2020

VAT
►October 13, 2020

International VAT Conference Webinar Series

Audits and Disputes
►September 9, 2020

Financial Services
►October 7, 2020

E-Commerce
►October 28, 2020

VAT Around the World
Part I
►November 18, 2020

VAT Around the World
Part II
►December 2, 2020

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projects in the pipeline that we expect to see soon include final and proposed Section 163(j) regulations (which will incorporate the legislative changes made by the CARES Act), proposed Section 1061 (carried interest) regulations, final regulations implementing Section 451, another foreign tax credit package (that may announce whether a digital service tax is creditable under section 903), and the infamous and complicated previously taxed earnings and profits ("PTEP") package.

Finally, the Organization for Economic Cooperation and Development ("OECD") is also very busy. On July 18, the OECD presented its international tax update to the G-20 Finance Ministers. The OECD aims to deliver blueprints for Pillar One (establishing a new nexus and reallocating taxing rights) and Pillar Two (ensuring a minimum level of taxation) of the G20/OECD Inclusive Framework on BEPS to the G-20 Finance Ministers at their October 2020 meeting. Given the recent correspondence from US Treasury Secretary Steven Mnuchin to certain European Union countries, it is unclear whether and how the United States will participate in the Pillar One discussions. The OECD also published model rules to address reporting of income in the gig and platform economy. The OECD is also considering expanding the Common Reporting Standard to include other financial type payments and crypto currencies, and work will continue throughout the summer.

For those of us lucky enough to lounge poolside this August, it looks like we will have plenty of reading to keep us occupied!

By: Alexandra Minkovich and Joshua D. Odintz Washington, DC and Christopher H. Hanna, Dallas

Tax Court Agrees that Settlement Payment is Sale of Partnership Interest and Not Lost Profits

In a recent case of *NCA Argyle LP v. Commissioner*, T.C. Memo 2020-56, the Tax Court held that a lump-sum payment of settlement proceeds to resolve a joint venture dispute between two partners resulted in capital gains and not ordinary income. *NCA Argyle LP* reminds taxpayers that settlement agreements should be closely scrutinized and negotiated from a tax perspective.

Facts

The facts of the *NCA Argyle LP* are relatively simple. Newport Capital Advisors, LLC ("NCA") entered into several real estate joint ventures with Commonfund Realty, Inc. ("Commonfund"). The parties had conflicts and struggled to formalize the terms of their deal into a written agreement. Eventually, Commonfund replaced NCA with another development company while NCA was still working on the projects. The parties ended up in litigation and the state court awarded NCA damages for the value of the joint venture interests repudiated by

Commonfund and punitive damages. The value of the award was estimated, in part, on the anticipated revenue stream of the joint ventures.

While that case was on appeal, the parties worked on a settlement. Based on advice from its tax advisor, NCA insisted on structuring the settlement as an exchange of NCA's joint venture interests for the settlement proceeds. After heavy negotiations, the parties settled for a lump-sum payment from Commonfund to NCA in exchange for NCA relinquishing whatever rights it had in the joint ventures. Further, NCA agreed to have no claim to any interest in any joint venture with Commonfund. Specifically, the settlement agreement provided: "[i]n consideration of the Payment due … NCA relinquishes and transfers to the Commonfund Parties, all of its rights, title, and interest (if any) in the joint venture(s) asserted by NCA that was (were) the subject of the Action."

Per the settlement agreement, NCA received a $23 million payment from Commonfund. NCA, indirectly through its affiliate entities, reported that payment as long-term capital gains. The IRS disagreed.

The IRS's Argument

NCA and the IRS agreed that the NCA entities may treat amounts received for the joint venture interests as capital gains under Code Section 741. NCA argued that the entire $23 million was in exchange for its joint venture interests. The IRS, however, argued that only $5 million was received for the joint venture interests and the remaining $18 million was received as compensation for lost fees and punitive damages, which are taxable as ordinary income. *See Estate of Longino v. Commissioner*, 32 T.C. 904, 905 (1959); *Greene v. Commissioner*, T.C. Memo. 1983-653. Specifically, the IRS argued that the "economic reality" of the $23 million payment was that Commonfund compensated NCA for loss of the joint venture interests and loss of future income from fees.

Tax Court's Holding

The Tax Court held for NCA. In citing *United States v. Burke*, 504 U.S. 229, 237, it acknowledged that the tax treatment of proceeds received in settlement of a claim is generally guided by the nature of the claim. It also noted that the nature of the underlying claim is a factual determination made by considering the settlement agreement in the light of all facts and circumstances. *Robinson v. Commissioner*, 102 T.C. 116 (1994). However, it recited the principals of *McKay v. Commissioner*, 102 T.C. 465, 482 (1994), which held that "express language in a settlement agreement is the most important factor" in determining why the settlement payment was made.

Then, the Tax Court pointed to the language of the settlement agreement, which provided that "[i]n consideration of the Payment … *NCA relinquishes and*

transfers to the Commonfund Parties, all of its rights, title, and interest (if any) in the joint venture(s) asserted by NCA that was (were) the subject of the Action." In the Tax Court's view, "[t]he plain text of this agreement is clear that NCA is receiving $23 million in exchange for the interests in the joint ventures." There was "[n]o portion of the payment … allocated elsewhere." In light of *McKay*, The Tax Court relied almost entirely on the settlement agreement as to the allocation of the payment and understanding of the parties (including the tax characterization). Given that NCA and Commonfund had adversarial tax interests and negotiated at arm's length regarding the nature of the settlement payment, the Tax Court concluded that their express allocation should be respected. Thus, the Tax Court held that the $23 million payment was proceeds from the sale or exchange of partnership interest, which are subject to capital gain treatment.

Analysis

As readers are well aware, under Code Section 741, the sale or exchange of a partnership interest is generally treated as a sale or exchange of a capital asset. This allows capital gain treatment, which is generally favorable to the seller of partnership interests. On the other hand, any amounts received as compensation for lost profits or punitive damages is treated as ordinary income to the recipient. *See Estate of Longino*, 32 T.C. at 905; *Greene*, T.C. Memo. 1983-653. Given the significant tax rate difference between the two types of income, it is easy to understand why NCA insisted on structuring the settlement agreement as a "sale" of NCA's joint venture interests for the settlement proceeds.

Despite the Tax Court's analysis and conclusion, the IRS's argument does have some merit. When arriving at the $23 million settlement amount, it is clear that the parties projected the future income of the proposed joint ventures that NCA lost. See *NCA Argyle LP* ("the expert valued the joint venture interests by considering future fees the joint ventures expected to receive"). When considering the punitive damages as well, the economic reality seems to be that that the $23 million settlement payment was paid in exchange for lost fees and punitive damages—both of which are ordinary income items to the recipient.

But the language of the settlement agreement was clear that the parties *expressly intended* the $23 million settlement to be in exchange for the partnership interest. This treatment allowed capital gain treatment for NCA (the seller) under section 741. In contrast, the parties could have structured the $23 million payment as a payment in exchange for lost fees. If so, the payment would have been treated as ordinary income to NCA, *see Estate of Longino*, 32 T.C. at 905, and a tax-deductible expense to Commonfund under Code Section 162(a)(1). Despite the parity in the tax consequences to each of them and the method of valuation, the parties negotiated to treat the settlement proceeds as an

exchange for partnership interests. Given that the parties had adversarial tax positions and extensively negotiated the settlement agreement, the Tax Court saw no basis to recharacterize this negotiated concept in light of the principals of *McKay*.

Conclusion

Settlement agreements should be closely scrutinized and negotiated from a tax perspective, and *NCA Argyle LP* reminds taxpayers of this valuable lesson. Also, *NCA Argyle LP* reminds taxpayers that it is "best practice" to specify the precise allocation and intended tax treatment of the settlement payments. This allows the parties to have certainty. Further, if the parties have adversarial tax consequences and negotiated in arm's length, their specification is more likely to be respected.

By: David Gong, Chicago

Rev. Proc. 2020-34: Relief for DSTs Amid the COVID-19 Pandemic

On June 4, 2020, the IRS released Rev. Proc. 2020-34 which provides three limited safe harbors allowing otherwise Rev. Rul. 2004-86 and Treas. Reg. § 301.7701-4(c) compliant Delaware Statutory Trusts ("DST") structured for use in Section 1031 like-kind exchanges to make certain modifications to their mortgage loans or lease agreements, or to accept certain additional cash contributions; without jeopardizing their federal income tax status as grantor trusts. In particular, the revenue procedure provides that such modifications or contributions are not treated as "manifesting a power to vary" the investment of the certificate holders, an action that would otherwise jeopardize the favorable tax treatment of the DST under the requirements of Rev. Rul. 2004-86 and Treas. Reg. § 301.7701-4(c) for qualification as replacement or relinquished property under Code Section 1031. The ability to utilize such safe harbors is limited to: (i) certain mortgage loan modifications requested or agreed to between March 27, 2020 and December 31, 2020, (ii) for leases entered into by the applicable DST on or before March 13, 2020, certain lease modifications requested and agreed to on or after March 27, 2020, and on or before December 31, 2020, and (iii) the acceptance of certain cash contributions from new or existing interest holder between March 27, 2020 and December 31, 2020. In addition, the language of the revenue procedure limits the utilization of safe harbors and additional cash contributions to DSTs that have experienced financial hardship (including indirectly due to tenants' financial hardship in the case of the lease modification safe harbor) due to the ongoing Coronavirus Disease 2019 ("COVID-19") pandemic and have undertaken such modifications or contributions as a result thereof.

Federal Response to COVID-19

In the nascent period of the COVID-19 pandemic, the U.S. Federal government provided broad relief to taxpayers when, on March 13, 2020, the President of the United States issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in response to the ongoing COVID-19 pandemic. The Emergency Declaration instructed the Treasury "to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate, culminating in the enactment of the Coronavirus, Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (the "CARES Act").

As the COVID-19 pandemic progressed, the Treasury turned its attention to more nuanced implications of the COVID-19 pandemic. On April 14, 2020, members of the Baker McKenzie's North American Tax Practice Group, in partnership with other practitioners, wrote the IRS with respect to the DST real estate investment industry, requesting the IRS to provide emergency relief to certain DST that own real property. The letter urged that, given the unprecedented economic crisis facing the United States resulting from the COVID-19 pandemic, many of the properties owned by DSTs are facing an operational crisis. While the challenges facing DST property owners are no different than those faced by other owners, DSTs are at a distinct disadvantage with respect to their ability to adjust to the current economic climate. In order to allow DSTs the ability to protect the investments of the beneficial owners, the letter requested that the IRS allow DSTs the right to undertake on a temporary basis, certain actions otherwise prohibited under Rev. Rul. 2004-86, including certain loan modifications, lease modifications, and acceptance of additional capital contributions.

Discussion of Rev. Proc. 2020-34

In response to this letter and similar comments from industry participants, the IRS and Treasury acted in response to the financial difficulties from the COVID-19 pandemic faced by impacted taxpayers, and issued Rev. Proc. 2020-34 to provide relief for trustees, commercial and residential tenants, lenders, and investors. The revenue procedure provides for the following three safe harbors:

Lease Modification

Leases are generally structured in one of two ways under a DST. First, if the property acquired is subject to a long-term net lease with a single commercial tenant, the DST will assume the lease with the tenant. If there is more than one tenant, the DST will frequently enter into a master lease arrangement with an affiliate of the DST sponsor, and the master tenant will sublease the property. Rev. Rul. 2004-86 states that the DST is prohibited from renegotiating its lease or entering into new leases, except in the case of the tenant's bankruptcy or insolvency. The identity of the applicable tenant for purposes of this exception

depends upon whether or not the DST utilizes a master lease, as discussed above. In the absence of a safe harbor, execution of a prohibited lease modification or re-leasing could cause the DST to lose its tax status as an investment trust, negatively impacting the ability of interest holders to use the DST in connection with a section 1031 like-kind exchange.

The COVID-19 pandemic has caused many commercial tenants to suffer a reduction in their cash flow, making it hard for many to remain current with their rent payments. This has led many tenants to ask for a modification on their lease in order to avoid default. Furthermore, the COVID-19 pandemic has caused widespread unemployment, causing many residential tenants to miss or delay their rent payments, especially since many states have issued orders prohibiting landlords from evicting non-paying tenants. The prohibition on lease modification has placed many DSTs and master tenants in a precarious position, as they are locked into underperforming but unchangeable leases but remain obligated to make full payment on their loan and rent obligations.

Under Rev. Proc. 2020-34, DSTs can modify a real property lease that they had entered before March 13, 2020. The lease can be modified to (i) coordinate the lease cash flows with the cash flows that result from a qualified forbearance (discussed below), or (ii) defer or waive one or more tenants' rental payments for any period between March 27, 2020 and December 31, 2020. In order to qualify for these modifications, two requirements must be met: (i) the modification were requested and agreed to by the DST and tenants between March 27, 2020 and December 31, 2020, and (ii) the tenants must be experiencing financial hardship due to the COVID-19 pandemic. Any modifications and amendments to a lease under Rev. Proc. 2020-34 must be given appropriate tax effect under the applicable provisions of the Code and regulations, including the provisions in Treas. Reg. § 1.467-1(f) relating to substantial modifications of section 467 rental agreements.

The lease modification safe harbor provides flexibility to allow DSTs to better prepare for the economic realities of this pandemic, and help tenants remain economically viable during the COVID-19 pandemic. Because of this safe harbor, DSTs will be able to receive partial rent payments instead of foregoing the entire amount, allowing both tenant and DST to come out of this pandemic in a stronger economic standing than they would have otherwise, while protecting DST interest holders' Section 1031 status.

Loan Modification

The COVID-19 pandemic has caused many borrowers to struggle staying current with their loan payments, including many DSTs. In order to avoid a foreclosure crisis, such as the one in 2009, lenders have shown a willingness to work with borrowers to modify the terms of their debt. However, under Rev. Rul. 2004-86, DSTs are prohibited from renegotiating the terms of the debt used to acquire the

property owned by the DST. This prohibition would generally not allow DSTs to take advantage of the modifications being offered by lenders, but the safe harbor under Rev. Proc. 2020-34 relaxes this prohibition under specific circumstances.

Rev. Proc. 2020-34 allows qualifying DSTs to modify a mortgage loan securing the DST's property by entering into a qualified forbearance program. The qualified forbearance program may fall under two categories: (i) a forbearance program being granted under the CARES Act; or (ii) a similar forbearance program of up to six months being provided to trusts experiencing financial hardship due to the COVID-19 pandemic and which was requested and agreed to between March 27, 2020 and December 31, 2020.

The loan modification safe harbor allows DSTs facing financial hardship to remain economically viable by modifying their loans, protecting lenders and DST interest holders.

Additional Cash Contributions

Rev. Rul. 2004-86 prohibits DSTs seeking investment trust treatment from accepting additional contributions of assets (including money). This prohibition makes DSTs particularly vulnerable to drastic changes in the economy that reduce rents produced by properties owned by the DST. Because additional cash contributions are prohibited, the DST has to continue paying its expenses with a reduced cash flow with no option for supplemental addition to capital. Furthermore, some lenders may only consider a loan modification if the borrower contributes additional capital, which could have prevented DSTs from entering into loan modifications, but for the additional cash contribution safe harbor.

Under Rev. Proc. 2020-34 a DST is allowed to accept cash contributions that are made between March 27, 2020 and December 31, 2020 as a result of the DST experiencing financial hardship due to the COVID-19 pandemic. In order to qualify, the contribution must be provided to (i) increase permitted trust reserves, (ii) maintain trust property, (iii) fulfill mortgage loan obligations, or (iv) fulfill real property lease obligations. Furthermore, if the contribution is made by new interest holders or is a non-pro rata contribution made by an existing interest holder, it will be treated as a taxable sale by each non-contributing interest holder of his proportionate interest in the DST's assets.

The additional cash contributions safe harbor creates optionality for a DST and its interest holders to decide if the investment is worth an additional contribution or to let the investment fail, instead of letting the COVID-19 pandemic decide for them.

The requirements under Rev. Rul. 2004-86 are too stringent for the economic conditions we are facing today. Rev. Proc. 2020-34 has eased those requirements and has allowed DSTs and their interest holders to face this

unprecedented situation in a much stronger position than they would have otherwise.

By: Peter Matejcak, Nick Serra, and Miguel Castro Morales, Chicago

Proposed Regulations on Deductibility of Certain Fines and Penalties and Related Information Reporting

On May 12, 2020, Treasury and the IRS issued long-awaited proposed regulations under Code Section 162(f), as amended by the Tax Cuts and Jobs Act ("TCJA") in 2017 that limits the deductibility of certain payments made to, or at the direction of, the government and other specified entities, in connection with a violation or potential violation of a law. The proposed regulations also provide guidance on the requirement imposed on the applicable governmental and non-governmental entities under section 6050X, newly enacted by the TCJA, to report information relating to such payments.

Prior to the TCJA, section 162(f) generally barred a deduction for fines and penalties paid to a government in connection with a violation of law unless the taxpayer could show that the payment was compensatory in nature. The TCJA broadened the scope of disallowance under section 162(f)(1) from fines and penalties paid to the government to *any* payments paid to, *or at the direction of*, the government or governmental entity (collectively, "government") in connection with a violation or *potential violation* of a law. The disallowance also extends to payments to, or at the direction of, a non-governmental entity, which exercises self-regulatory powers in connection with a qualified board or exchange, or as part of performing essential governmental functions. Congress, in particular, wished to prevent taxpayers from deducting settlement payments aimed at punishing their wrongdoings and undermining the deterrent effect of such penalty as a result. However, section 162(f)(2) provides an exception to the non-deductibility rule for a payment that the taxpayer establishes as restitution, remediation, or an amount paid to comply with the law (the "Establishment Requirement"), and that is identified as such in a court order or a settlement agreement (the "Identification Requirement").

New section 6050X requires the relevant governmental or non-government entity involved in a suit or an agreement subject to section 162(f)(2) to file an information return with the IRS to report the amount required to be paid pursuant to an order or an agreement, and any portion that constitutes restitution, remediation, or payments to come into compliance with the law. A written statement must also be provided to the party to the suit or agreement.

Proposed Regulations Under Section 162(f)

The proposed regulations under section 162(f) adopt the general rule of disallowance set forth in section 162(f)(1) and clarify that this provision applies "regardless of whether the taxpayer admits guilt or liability or pays the amount imposed for any other reason, including to avoid the expense or uncertain outcome of an investigation or litigation." Notice of proposed rulemaking, REG-104591-18, 85 Fed. Reg. 28524, 28526 (May 13, 2020). However, section 162(f) does not prohibit a deduction for amounts paid or incurred for audits, inspections, or reviews conducted in the ordinary course of business if the payment is otherwise deductible and is not related to a violation of a law or the investigation or inquiry into a potential violation of a law.

Consistent with the statute, the proposed regulations allow a deduction for an amount paid or incurred to, or at the direction of, a governmental or another identified entity as restitution or remediation, or to come into compliance with a law, if the taxpayer establishes that the amount was paid or incurred for such purpose. Under the proposed regulations, an amount paid or incurred as restitution or remediation is defined as an amount that cures, in whole or in part, the harm to a person, government, or property caused by the violation or potential violation. A payment made to comply with a law may arise from performing services, taking actions, such as modifying equipment, providing property, or a combination of these activities.

On the other hand, restitution, remediation, and amounts paid to come into compliance with a law do not include amounts paid or incurred (i) to reimburse for the government's investigation or litigation costs, (ii) at payor's election, in lieu of a fine or penalty, (iii) as forfeiture or disgorgement, or (iv) as a payment or contribution, which does not constitute restitution, remediation, or an amount paid to comply with the law, to an entity, fund, group, or government. In particular, the preamble, based on a recent Supreme Court decision addressing disgorgement in the context of federal securities law, explains that forfeiture and disgorgement do not fall under the restitution exception because they are designed to prevent the "unjust enrichment of the wrongdoer," rather than "to make victims whole by reimbursing them for their losses." 85 Fed. Reg. at 28527.

The proposed regulations provide guidance on how taxpayers can satisfy the Identification and Establishment Requirements, which must be separately substantiated to claim the exception under section 162(f)(2). An order or agreement must state the nature of, or purpose for, each payment the taxpayer is obligated to pay and identify the amount of each payment to fulfil the Identification Requirement. The requirement is presumed to be met if the order or agreement specifically states that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law, or states so using a different form of the required words, such as "remediate" or "comply with

the law." Where the taxpayer is required to provide services or property, or perform a specific action, an order or agreement that does not specify the amount may suffice if it "describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer." Prop. Reg. § 1.162-21(b)(2)(iii). These characterizations, however, are not binding on the IRS, which may rebut the presumption with sufficient contrary evidence. Further, information reports submitted by the government pursuant to section 6050X alone will not satisfy the Identification Requirement.

Under the proposed regulations, the taxpayer can satisfy the Establishment Requirement by substantiating with documentary evidence (i) the taxpayer's legal obligation to pay the amount the order or agreement identified as restitution, remediation, or a legal compliance cost, (ii) the amount paid, and (iii) the date the amount was paid or incurred. The proposed regulations provide a list of non-exhaustive documents the taxpayer can use but, similar to the Identification Requirement, expressly preclude sole reliance on the information return filed pursuant to section 6050X. Meeting the Identification Requirement alone also is not sufficient to meet the Establishment Requirement.

Amended section 162(f) does not apply to amounts paid or incurred under a binding order or agreement entered into before December 22, 2017. The proposed regulations clarify that if the parties make a "material change" to the terms of such order or agreement on or after the applicability date of the regulations, then amended section 162(f) applies to amounts paid or incurred and obligations to provide services or property on or after the date of the change. A "material change" is broadly defined to include (i) changing the nature or purpose of a payment obligation, or (ii) changing, adding to, or removing a payment obligation or an obligation to provide services or property.

The rules under the proposed regulations would apply to taxable years beginning on or after the date the finalized regulations are published in the Federal Register. Taxpayers may rely on the proposed regulations in the meantime, but only if applied in their entirety and in a consistent manner.

Proposed Regulations Under Section 6050X

The proposed regulations under section 6050X provide the rules for governmental officials subject to the statutory information reporting requirement. Generally, the appropriate official of the government, which is a party to an order or agreement, must file an information return with the IRS if the aggregate amount the payor must pay equals to or exceeds $50,000. The information return reports (i) the aggregate amount required to be paid, (ii) the separate amounts required to be paid as restitution or remediation, or to come into compliance with a law, and (iii) any additional required information. Reporting is required even if an order or agreement does not specify an amount but the

government expects the amount to equal to or exceed $50,000. The appropriate official also must furnish to the payor a written statement that includes the information reported to the IRS on or before the date the official files the information return.

The proposed regulations eased the administrative burden by increasing the reporting threshold from $600 in the statute to $50,000 and by requiring submission of the information return on or before the annual due date, rather than at the time the agreement takes effect. Further, the rules set forth in the proposed regulations would apply only to orders and agreements that become binding on or after January 1, 2022.

Conclusion

The proposed regulations under sections 162(f) and 6050X, while providing much needed clarity for taxpayers and the relevant government authorities, highlight the need for taxpayers to closely document the costs to restore, remedy, and comply with a law in order to claim a deduction under the exception. The proposed regulations also show that the payment must compensate rather than serve retributive or deterrent purposes. As such, taxpayers should carefully negotiate the language of the order or agreement to reflect such purpose to the extent permitted by the underlying facts and claim to preserve the deductibility of the payment.

By: Christine Kim, Washington, DC

Retirement Relief Provisions Accessible to More Taxpayers

As described in our previous alert, "*Important Implications Coronavirus Aid, Relief and Economic Security Act in US*," Section 2202 of the CARES Act provides that "qualified individuals" may take coronavirus-related distributions from eligible retirement plans (such as Code sections 401(k), 403(b), and 457(b) plans, and IRAs) between January 1, 2020 and December 31, 2020, without incurring the normal 10% early withdrawal penalty and without immediately recognizing the distributed income for tax purposes. Instead, such income is recognized ratably over three years unless the taxpayer elects to recognize the full amount in the current year. Further, coronavirus-related distributions are capped at an aggregate limit of $100,000 from all plans and IRAs, and may be rolled-over during an extended three-year period (rather than the usual 60-day period) to reverse the tax consequences and continue tax deferral. The CARES Act also increases the limit on the amount a qualified individual may borrow from an eligible retirement plan (not including an IRA) and permits a plan sponsor to provide qualified individuals up to an additional year to repay their plan loans.

In Notice 2020-50, 2020–28 I.R.B. 35 (the Notice), the IRS clarified that employers have the option of adopting the distribution and loan rules of section 2202 of the CARES Act. An employer is permitted to choose whether, and to what extent, to amend its plan. If an employer does not treat a distribution as coronavirus-related, however, a qualified individual may treat a distribution that meets the requirements to be a coronavirus-related distribution as coronavirus-related on the individual's federal income tax return. The Notice also clarifies that certain distributions can never be treated as coronavirus-related distributions (for example, distributions to correct section 402(g), section 415 or ADP/ACP test results).

Qualified Individuals

In the Notice, the IRS also expands the definition of a qualified individual. Under the CARES Act, as written, a qualified individual was limited to:

- a plan participant who is diagnosed (or whose spouse or dependent is diagnosed) with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID-19) by a test approved by the Centers for Disease Control and Prevention; or
- a plan participant who experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury.

After receiving comments from the public requesting broader relief, the IRS expanded the definition of a qualified individual in the Notice to include an individual who experiences adverse financial consequences as a result of:

- the individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19;
- the individual's spouse or a member of the individual's household being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of childcare due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or
- closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19.

The administrator of an eligible retirement plan may rely on an individual's certification that the individual satisfies the conditions to be a qualified individual in determining whether a distribution is a coronavirus-related distribution, unless the administrator has actual knowledge to the contrary. A sample certification form is included in the Notice. The Notice noted, however, that individuals must actually be qualified individuals to take advantage of this relief on their returns.

Employers report payments of a coronavirus-related distribution on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*. If a payor is treating the payment as a coronavirus-related distribution and no other appropriate code applies, the payor may use distribution code 2 in box 7 of Form 1099-R.

In order to receive favorable treatment for the distribution, a qualified individual reports a coronavirus-related distribution on the individual's federal income tax return for 2020 and on Form 8915-E, *Qualified 2020 Disaster Retirement Plan Distributions and Repayments*. The qualified individual must include the taxable portion of the distribution in income ratably over 2020, 2021, and 2022 unless the individual elects to include the entire amount in income in 2020.

Rollover of Coronavirus-Related Distributions

A qualified individual who receives a coronavirus-related distribution that is eligible for tax-free rollover treatment may recontribute, at any during the three-year period beginning on the day after the date on which such distribution was received, any portion of the distribution to an eligible retirement plan that accepts eligible rollover contributions. However, eligible retirement plans are not required to change their terms or procedures to accept repayments. Repayment of a coronavirus-related distribution is determined and reported for any year on Form 8915-E.

The Notice provides several examples of recontribution timing for tax purposes. The examples demonstrate that where a qualified individual has elected to include the entire amount in income in 2020, recontributed amounts paid before the due date for the timely-filed income tax return (including extensions) for 2020 are not included in gross income. For any amounts recontributed after the due date for the timely-filed income tax return (including extensions) but during the three-year rollover period, the qualified individual must file an amended return.

For qualified individuals including the income ratably over the three-year rollover period, a recontribution of any portion of the coronavirus-related distribution before the due date for the timely filed income tax return (including extensions) for a tax year in the three-year rollover period, the amount of the recontribution will reduce the ratable portion of the coronavirus-related distribution that is includible in gross income for that tax year. The qualified individual may then carryforward or carryback (using an amended return) any excess amount above

the ratable portion for that year to reduce the ratable portion for other tax years in the three-year rollover period.

Loan Relief

Section 2202(b)(2) of the CARES Act permits an additional year for repayment of loans from eligible retirement plans (not including IRAs) and section 2202(b)(1) relaxes limits on loans. If a loan is outstanding on or after March 27, 2020, and any repayment on the loan is due from March 27, 2020, to December 31, 2020, that due date may be delayed under the plan for up to one year and then reamortized (taking into account interest) over a period that is up to one year longer than the original term of the loan. The Notice provides a safe harbor if a qualified individual's obligation to repay a plan loan is suspended under the plan, but also noted that there may be other reasonable ways to administer these rules.

The CARES Act also permits employers to increase the maximum loan amount under section 72(p)(2)(A) available to qualified individuals. For plan loans made to a qualified individual from March 27, 2020, to September 22, 2020, the aggregate limit may be increased up to the lesser of: (1) $100,000 (minus any outstanding plan loans of the individual), or (2) 100 percent of the individual's vested benefit under the plan.

The Notice expands upon Coronavirus-related relief for retirement plans and IRAs questions and answers released by the IRS on May 4, 2020.

By: Elizabeth Boone, Dallas

Cameco Corporation: Recharacterization Does Not Mean Ignoring Transactions as Structured by the Taxpayer

The Federal Court of Appeal recently ruled in *The Queen v. Cameco Corporation*, 2020 FCA 112 ("*Cameco*") that the recharacterization power in paragraphs 247(2)(b) and (d) of the Canadian Income Tax Act does not allow the Minister to simply ignore a transaction and impose income tax as if the transaction had not occurred. This decision helps to clarify that the recharacterization power is limited in scope and is an objective test.

At issue in *Cameco*, was whether the profits earned by a foreign subsidiary should be included in the income of the foreign subsidiary or in the income of the Canadian parent company. The Tax Court (*Cameco Corporation v. The Queen*, 2018 TCC 195) had found that the profits should be included in the income of the foreign subsidiary, in accordance with the underlying agreements, because the transactions were not a sham, were commercially reasonable, and were on terms and conditions that would have been entered into by arm's length parties: neither

the pricing rule nor the recharacterization rule applied. The issue before the Federal Court of Appeal was whether the recharacterization rule, which allows for the recharacterization of transactions where the taxpayer has entered into a transaction that would not have been entered into by arm's length parties, under any terms or conditions, should apply to Cameco's transactions.

The Canadian parent company initially formed a foreign subsidiary (Cameco Europe S.A. ("CESA"), a Luxembourg subsidiary with a Swiss branch) to handle international sales of uranium. The Canadian parent company was one of several suppliers to CESA. CESA was part of a consortium (that also included the CEO of the Canadian parent company) that negotiated uranium purchase agreements with two primary arm's length suppliers. A few years later, Cameco Europe AG (SA, Ltd) ("CEL"), a Swiss subsidiary, was formed and the business of the CESA, including the purchase agreements, was transferred to CEL. At the time of these transactions it was not known that the price of uranium would spike. In fact, the price had traded within a very narrow range for decades at that point. However, the price of uranium unexpectedly rose resulting in CESA/CEL realizing significant trading profits.

The Canadian government took the position that the recharacterization rule should apply to include these uranium trading profits in the income of the Canadian parent company because the Canadian parent company would not have entered into the transactions with the foreign subsidiaries had the parties had been dealing at arm's length. In finding for the taxpayer, the Federal Court of Appeal found that the recharacterization rule does not ask whether the particular taxpayer would have entered into the transactions with arm's length parties. Rather, the test is objective: would hypothetical arm's length parties have entered into the relevant transactions, under any terms or conditions. The answer was yes. Accordingly, the recharacterization rule did not apply.

There are some important observations that arise from this decision.

1. Recharacterization does not mean ignore or disregard: At paragraph 53, the FCA stated:

> Paragraph 247(2)(d) of the Act requires the Court to replace the transaction or series of transactions that was entered into between the participants with the transaction or series of transactions that would have been entered into between persons dealing with each other at arm's length. It contemplates replacing the existing transaction or series of transactions with some other transaction or series of transactions. It does not contemplate replacing the existing transaction or series of transactions with nothing, which is the result proposed by the Crown in paragraph 4 of its memorandum: "Cameco Canada would not have entered into any transactions with its Swiss subsidiary if they had had been dealing at arm's length".

> Treating Cameco as if it had not entered into any transactions with CEL would, in effect, result in the separate existence of CEL being ignored or effectively CEL being amalgamated with Cameco.

The Courts in Canada have consistently focused on the importance of contracts and will not easily set valid contracts aside. In this case, the TCC spent considerable time focused on the validity and importance of the contracts and the responsibilities and risks attendant with the contracts. The FCA did not disturb that focus.

2. Legal substance is to be respected. At paragraph 60, the FCA stated:

> Section 247 is in Part XVI.1 with the heading: "Transfer Pricing". For subsection 247(2) of the Act, the heading is "Transfer Pricing Adjustment". These headings support an interpretation of subsection 247(2) of the Act that would result in an adjustment in the pricing of the relevant transactions, rather than an interpretation that would allow the Minister to pierce the corporate veil of CEL and reallocate all of its profits to Cameco.

While much is being made at the OECD about people functions having greater importance than contractual arrangements, the FCA has made clear that legal substance and the legal structure must be respected and the transfer pricing rules do not give the CRA the power to ignore such factors.

Ultimately, Canada's income tax and transfer pricing regime is designed to facilitate companies doing business internationally and through a network of treaties, to allocate taxing authority and provide necessary mechanisms for multinationals to efficiently structure their operations to be competitive globally while avoiding adverse consequences in foreign jurisdictions. This case makes clear that foreign subsidiaries and intercompany contracts cannot simply be set aside such that a Canadian parent is taxed in Canada as if it carried on its global business by itself directly from Canada.

By: Alex Pankratz and Chris Raybould, Toronto

New Mandatory Disclosure Rules in Mexico - "Reportable Schemes"

Key Considerations

Mexico has introduced new provisions into its domestic tax law that may be considered as the Latin American version of the Council Directive ("EU") 2018/288 of 25 May 2018 ("DAC 6"). This derived from the Mandatory Disclosure

Rules under Action 12 of the OECD BEPS Project in an attempt by the Mexican Treasury to know what taxpayers are doing in terms of tax planning and tackle aggressive transactions having a tax avoidance or abuse component.

Consequently, the Mexican Federal Tax Code ("FTC") now sets forth the obligation (starting January 1st 2021) for tax advisors or, alternatively, taxpayers to disclose information about ***"reportable schemes"*** (defined) to the Tax Administration Service ("SAT") in cases where such schemes, when entered into by taxpayers, directly or indirectly, result in a tax benefit in Mexico.

These new reporting rules are embodied in Articles 197 through 202 of the FTC, become effective as of January 1st 2021 and apply to either tax advisors (as defined in the FTC -see *Relevant Definitions* below) or to taxpayers, regardless of the taxpayers' tax residency.

The obligation to report will lie solely on taxpayers in the case of transactions and/or structures entered into and/or implemented by the taxpayer before 2020, provided that they represent a continuous tax benefit during 2020 and onwards.

For the avoidance of doubt, the FTC expressly defines the concept of "tax advisor" and the concept of the term "scheme", and distinguishes generic schemes from personalized schemes. However, unlike DAC 6 (which clearly establishes references to elements of transactions that present a strong indication of tax avoidance or abuse, referred to as "hallmarks", from which exceptions for reporting may apply) the FTC contains a list referring to specific schemes that, upon meeting certain characteristics, will be deemed reportable, with no exceptions.

Nevertheless, the SAT is yet to issue administrative guidelines and certain exception thresholds that should shed light to taxpayers and help determine whether or not a given scheme is reportable or not in terms of this new reporting obligation.

Relevant Definitions

For purposes of this reporting obligation, the FTC expressly defines the following basic terms:

Tax Advisor**:** any legal entity or individual who: (i) is engaged in tax consulting in the ordinary course of business and is responsible or is involved in the design, commercialization, organization, implementation or management of the totality of a reportable tax scheme; or (ii) is <u>involved in the totality</u> of tax advice for a reportable tax scheme that would be implemented by a third party. According to the 2020 Tax Reform statement of purpose, (but not the statute, itself), the phrase "involved in the totality" was included by the legislators in order to clarify

that in cases where (i) a given tax advisor was engaged only in a single step of a reportable scheme (i.e. as opposed to the totality) and (ii) consequently, this deprived the tax advisor from having full knowledge of all of the tax effects/benefits of such scheme for the taxpayer, then the reporting obligation cannot apply to such tax advisor.

Tax advisors include residents and non-residents with a permanent establishment (“PE”) in Mexico, provided that the services rendered are attributable to such PE. A rebuttable presumption applies with regard to a non-resident tax advisor with a PE or a related party in Mexico, in terms of which, the advice will be deemed provided by the Mexican presence. The same will apply when the advisor, being a resident of Mexico, performs tax consultancy services under the same commercial name of tax advisors residing abroad. In those cases where the non-resident renders the service, it will be the PE, the related party or the third party the one required to report the scheme.

The following is a description of some of the more important defined terms:

“Tax Benefit”**:** *the monetary value* of any reduction, avoidance, or temporary deferral of taxes, including, by way of deductions, tax-exempt treatments, no-recognition of gain or taxable income, adjustments or lack thereof in the taxable base, tax credits, the reclassification of certain payment or activity, a change in tax regime, etc. For purposes of this reporting obligation, this term is defined [as the monetary value of] by reference to the concept of “tax benefit” under Mexico’s new GAAR (contained in Article 5-A of the FTC) -i.e. tax reduction, avoidance, or temporary tax deferral, including, by way of deductions, tax-exempt treatments, no-recognition of gain or taxable income, adjustments or lack thereof in the taxable base, tax credits, the reclassification of certain payment or activity, a change in tax regime, etc.

“Taxpayer”: Any legal entity or person subject to tax in Mexico, regardless of that entity/person’s tax residency.

As noted, reportable schemes must be disclosed regardless of the tax residence of the taxpayer, if the latter obtains a tax benefit in Mexico.

“Scheme”**:** any plan, project, proposal, advice, instruction or recommendation made tacitly or expressly with the aim of implementing a number of transactions. Formal filings before the tax authorities or the defense of taxpayers within the context of tax disputes are not considered schemes.

“Generic scheme”**:** a scheme intended to be commercialized massively to any kind of taxpayers or a specific group thereof, where the manner in which the tax benefit is obtained is the same, even if the scheme must be customized to the specific circumstances of a given taxpayer.

"Personalized scheme"**:** a scheme designed, commercialized, organized, implemented or managed for the special circumstances of a given taxpayer.

"Reportable scheme"**:** a scheme expressly listed in Article 199 of the FTC, which triggers or may trigger, directly or indirectly, a tax benefit in Mexico and if they have any of the following characteristics (to name a few):

- Avoid the exchange of tax information under the Foreign Account Tax Compliant Act ("FATCA") and the Common Reporting Standard ("CRS").
- Avoid the application of the new rules regarding fiscally transparent entities under Article 4-B of the Mexican Income Tax Law ("MITL").
- Avoid the application of Mexico's CFC rules established under Chapter I, Title VI of the MITL.
- Avoid the identification of the beneficial owner of the incomer or assets. Including the use of foreign entities or legal figures to avoid the identification or designation of the beneficiaries at the time of their incorporation.
- Consists of a transaction or a series of transactions allowing the transfer of tax losses to an entity different to the one that generated them.
- Consists of a transaction or a series of interconnected transactions that refund the totality or part of the initial payment part of these series of transactions to the person that made it or to its partners or related parties.
- Involves a non-resident to apply an income tax treaty ("DTC") executed with Mexico regarding income not subject to taxation in the country of tax residence of the taxpayer; the same would apply when the income is subject to a rate lower than the corporate rate applicable in the country of residence of the taxpayer.
- Involves related-party transactions, in certain specific cases.
- Other similar transactions.

A "catch-all" provision is also included to consider any mechanism avoiding the application of the expressly listed schemes as reportable.

Informative Return - Responsible Party, Timing, Legal Effects

Responsible Party

As a general rule, this obligation applies to tax advisors, however, exceptionally, this obligation will apply to taxpayers, who must report directly a given scheme when:

- The tax advisor does not provide the identification number -see *Legal Effects* below- corresponding to the reportable scheme.

- They have designed, organized, implemented and managed the reportable scheme.
- They obtain tax benefits in Mexico from a scheme that has been designed, commercialized, organized, implemented or managed by a person that is not considered a tax advisor or does not have a presence or permanent establishment in Mexico.
- The tax advisor has a legal obstacle to disclose the scheme.
- They agree with the tax advisor that they would report the corresponding scheme.
- The scheme was designed, commercialized, organized, implemented or managed before 2020 if the tax effects of such scheme are reflected in 2020 onwards, case in which (as noted above) the obligation to report relies solely on the taxpayer.

Timing

Generalized reportable schemes must be disclosed within 30 days following the first contact made for their commercialization, that is, the first action for third parties to know the existence of the scheme.

Personalized reportable schemes must be disclosed within 30 days following the date the scheme is available to the taxpayer for its implementation or the date the first transaction related to the scheme is performed.

The tax advisors and taxpayers required to disclose the reportable scheme may disclose it once they have completed their design.

Legal Effects

The disclosure of a reportable scheme must be made through the filing of an informative return. However, this does not imply the acceptance or rejection of the corresponding tax effects by the SAT.

The information provided through the disclosure of a reportable scheme cannot be used to initiate a criminal action, except in those cases regulated by Articles 113 and 113 Bis of the FTC -*i.e.*, tax crimes related to the issuance or acquisition of false invoices, destruction of accounting records, etc.

The information gathered through the reportable scheme mechanism should be treated as reserved and confidential in terms of Article 69 of the FTC, which provides the obligation for the tax authorities to keep the information under their possession or control confidential.

(i) Reportable Scheme Identification Number

Upon filing the informative return, an identification number for each reportable scheme will be given by the SAT to the tax advisor or taxpayer. Also, the SAT will provide them with a copy of the informative return used to disclose the reportable scheme as well as the corresponding certificate assigning the identification number of the specific reportable scheme.

A request for additional information may be made by the SAT, in which case, tax advisors or taxpayers would be required to provide such additional information or provide a statement under oath stating that they do not have it. This response should be made within 30 days following the specific request of information. If the information request is not met or extemporaneously met, the fines described further below would apply.

(ii) Taxpayers and the information needed in their annual tax return.

In terms of Article 202 of the Tax Code, taxpayers disclosing a reportable scheme are required to provide the identification number of the scheme in their annual tax return corresponding to the year in which the scheme was implemented and in the tax returns of the years during which the scheme is in effect.

Final Remarks

By now, tax advisors and taxpayers should be aware that any transaction or structure being currently designed, marketed, organized, implemented, or managed in favor of a taxpayer must be analyzed in light of the corresponding tax treatment applicable in terms of Mexican tax law to determine (i) if it may yield a tax benefit in Mexico, and (ii) whether or not it should be reported in fiscal year 2021.

Therefore, to consider if a given transaction/structure is subject to these new mandatory disclosure rules in Mexico, a conservative approach as of the enactment of these rules (December 9, 2019) and until the thresholds and exception rules are published by the SAT, would require tax advisors and taxpayers alike to begin the analysis of, either:

(i) a structure implemented in the past (i.e. before 2020) and currently in place granting tax benefits in Mexico, or

(ii) any tax advice (in and of itself) provided to/received by taxpayers with respect to certain transaction or structure granting a tax benefit, in order to:

- First, determine whether or not such transaction/structure qualifies as a “scheme”;
- Secondly, determine whether the person who advised on such transaction falls under the definition of “tax advisor”;
- Then, determine whether or not the tax advisor is “involved in the totality” of the design, marketing, organization, implementation, or management of said scheme so as to allow the taxpayer to obtain a tax benefit in Mexico, and
- Finally, to conclude which party may be deemed responsible for filing the corresponding informative return.

Updates on the Mexican Manufacturing and Maquiladora Industries

COVID-19 and the Manufacturing and Supply Chain Operations

Although COVID-19 represents a widespread disruptive event for the global economy, it has a very distinctive implication on manufacturing operations and the supply chain of goods. Specifically, social distancing and other measures implemented to mitigate the risk of additional spread of the virus is resulting in the disruption of manufacturing activities, as companies were forced to downsize their productive output due to space constrains, and for non-essential activities they were required to temporary shut down operations. Moreover, there are other collateral and relevant effects related to the supply chain, and on one side of the equation there is a disruption on the supply of parts, components or subassemblies necessary to manufacture export products, and on the other side of the equation there is a lower demand of products by the principal of the maquiladora.

In light of the COVID-19, several multinational companies have decreased liquidity, which raises the question as to whether or not a low-risk company, such as a maquiladora, could attribute to its own operations a given amount of losses created due to a force majeure event (i.e. whether or not the salary payment of workers who did not work for the company during the epidemic event should be treated as an ordinary or extraordinary expense, and whether or not such payments could lower the profits by demonstrating that such losses are not attributable to transfer pricing but rather to economic circumstances). Although the Income Tax Law provides a more clear guidance with respect to maquiladora companies that determine their taxable profit by following the so-called “Safe Harbor” provision, the issue is less clear with respect to companies that applied for an Advanced Pricing Agreement (“APA”) with the Mexican tax authority. Maquiladora companies may have to refine the segregation of ordinary and extraordinary expenses, as well as to identify any other activity different form the maquiladora operation. Moreover, the economic disruption may also create the

need of revising the set of tested parties for comparable transactions, with the known difficulties related to the availability of reliable information to undertake a refined analysis that considers not only the economic circumstances of the tested parties in the current economic downturn, but also the effect for a multi-year approach under which the APAs are issued.

By: Jorge Narváez-Hasfura and Javier Ordoñez, Mexico City, and Juan Carlos Valles, Juarez

High Net Worth Taxpayers Face IRS Wealth Squad

Examinations are likely to address taxpayers with passthroughs and private foundations, among others. High net worth taxpayers should ensure they understand how the IRS's high wealth audit campaign can affect them and how to address an IRS Wealth Squad audit.

For additional information, please see Baker McKenzie client alert, "*High Net Worth Taxpayers Face IRS Wealth Squad*."

By: Paul DePasquale, New York

A "Manufactured" Attack: Department Takes Aim at Contract Manufacturing and Redrafts the Tax Law in New Draft Regulations

On the heels of its loss in *Matter of TransCanada Facility USA, Inc.* DTA NO. 827332, on May 14, the New York State Department of Taxation and Finance proposed draft regulations addressing the Article 9-A Franchise Tax treatment of Qualified New York Manufacturers ("QNYMs"). As background, beginning in 2014, the New York Legislature enacted a special 0% tax rate on business income (and corresponding special rates on the capital base and fixed dollar minimum tax) available for corporations meeting the definition of a QNYM. Shortly after the QNYM statute became effective, the Department issued a Technical Services Bureau Memorandum announcing its position that companies outsourcing a portion of the manufacturing process to contract manufacturers would not qualify for QNYM treatment. The Department formulated its "anti-contract manufacturing" position notwithstanding the lack of any supporting authority in the statute or the accompanying legislative history, and in spite of the fact that, under a longstanding body of jurisprudence, companies hiring contract manufacturers *can* qualify as manufacturers for other tax purposes. In the recently published draft regulations, the Department has amplified its position that contract manufacturing is not "manufacturing" for QNYM purposes. In addition, the draft regulations attempt to exclude digital activity from the definition

of manufacturing, even though the QNYM statute itself broadly applies to the production of "goods," not just *tangible* goods, by manufacturing. These draft regulations clearly represent an attempt by the Department to rewrite the QNYM statute to permit a much more limited class of taxpayers to qualify for the 0% business income and other special tax rates. For more information on these and other recent state and local tax updates, please see "A 'Manufactured' Attack: Department Takes Aim at Contract Manufacturing and Redrafts the Tax Law in New Draft Regulation" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Nicole Ford, New York

Recent California State and Local Tax Developments

As summer heats up in the Golden State, so has the action involving California state and local taxes. Several legislative and judicial decisions of significance to taxpayers doing business in California have come out in recent weeks. Below are some of these recent developments.

State Budget Includes Familiar Temporary Tax Measures

On June 29, 2020, Governor Newsom signed California's budget package for the fiscal year beginning July 1. One of the more notable provisions was included in Assembly Bill 85. That bill is expected to generate an estimated $9.2 billion in additional revenue over three years in an attempt to alleviate California's projected budget shortfall due to COVID-19 by temporarily suspending utilization of net operating losses. In particular, AB 85 prevents taxpayers with income of $1 million or more from utilizing NOLs for taxable years beginning between January 1, 2020 and December 31, 2022. Suspending NOL utilization is nothing new in California. The state took the same measure in the aftermaths of the dot-com bubble (2002-2003) and the great recession (2008-2011). Furthermore, while those prior suspensions, like the current suspension, included extensions of the NOL carryover period, it is worth noting that the FTB interpreted those carryover extensions narrowly to allow an extension only when a taxpayer could not have otherwise utilized the NOLs. The validity of that interpretation is still an open question.

AB 85 also implements a cap of $5 million on the utilization of business tax incentives. This cap would apply to important credits that include the R&D credit, the California Competes Tax Credit, motion picture production credits, jobs tax credit, and others. Many credits subject to the limitation would be carried over into the next taxable year. Of course, this limitation would have an effect of targeting in-state companies that create needed jobs in these times of economic uncertainty.

"Majority" Rules: California Court of Appeal Rules that Supermajority not Needed to Pass Voter Initiative Tax Measures

In *City & County of San Francisco v. All Persons Interested in the Matter of Proposition C*, Dkt. A158645 (Cal. App., June 30, 2020), the California Court of Appeal upheld Proposition C—a voter initiative that created a new business tax in San Francisco. The court held that the initiative was valid when enacted by a simple majority of electors, rejecting the argument of several business associations and amicus curiae that such initiatives must be approved by two-thirds of voters. This question—i.e., whether voter-initiative taxing measures must pass by a majority or supermajority—has been heavily debated since the California Supreme Court's decision in *California Cannabis Coalition v. City of Upland*, 3 Cal. 5th 924 (Cal. 2017).

For background, Citizens' initiative power—that is, "the power of the electors to propose statutes and amendments to the Constitution and to adopt or reject them"—has been enshrined in the California Constitution for over 100 years. *See* Cal. Const. Art. II § 8. In general, measures placed on the ballot via a voter initiative must generally be approved by a majority of voters in an election to become effective. However, two separate voter initiatives—Proposition 13 in 1978 and Proposition 218 in 1996—provided safeguards on new taxes by requiring certain taxing statutes and ordinances to be approved by a *two-thirds supermajority* in a general election. Prior to the California Supreme Court's 2017 decision in *Upland*, it was widely understood, notwithstanding the majority vote provisions applicable to initiatives generally, that local taxing statutes were subject to the supermajority requirements prescribed in Propositions 13 and 218. In *Upland*, while the California Supreme Court did not directly address the majority vs. supermajority voting requirement as applied to voter initiative taxes, the Court's decision did include language that was interpreted by some as creating doubt on the decades-long understanding of the local tax limitations.

After the *Upland* decision, several voter initiatives imposing local taxes were added to ballots. This included the business tax imposed by Proposition C, an Oakland parcel tax increase, a Fresno sales tax increase, a transient occupancy tax in Del Norte County, and others. Each of these voter initiatives passed by majority (but not supermajority) vote. Thus courts began reviewing the supermajority requirement to determine if those tax measures are valid. The Court of Appeal's recent decision in *Matter of Proposition C* focuses on the San Francisco Homelessness Gross Receipts Tax. The trial court found in favor of the City in July 2019, ruling that under *Upland*, the supermajority requirement did not apply to voter initiatives. On June 30, 2020, the Court of Appeal upheld the decision of the trial court, concluding that the law must be interpreted broadly in favor of giving effect to the Proposition C voter initiative. The business associations are expected to seek review from the California Supreme Court. In the interim, given the appellate court's holding that local tax increases could pass

by simple majority, there may predictably be a further increase in voter initiative tax measures.

California Court of Appeal Holds That a Trust's Entire California Source Income Is Subject to Tax

The California Court of Appeal recently issued its decision in the closely watched "Paula Trust" case, holding that all of a trust's California source income was subject to California income tax even though one of the trustees was a nonresident. *See Steuer v. Franchise Tax Board*, No. A154691 (Cal. Ct. App. 1st Dist. June 29, 2020). The primary issue in *Steuer* was whether a trust with both California resident and nonresident trustees is permitted to apportion *all* of its income, or only that portion of its income not derived from California sources.

By statute, California imposes income tax on 100% of a trust's income if all trustees or all non-contingent beneficiaries are California residents. Cal. Rev. & Tax. Cd. § 17742(a). If the taxability of a trust's income depends on the residence of its trustee and there are two or more trustees, the taxable income must be apportioned to California "according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board." Cal. Rev. & Tax. Cd. § 17743. California Franchise Tax Board ("FTB") regulations provide that if one or more trustees are California residents and one or more trustees are nonresidents, the trust is taxable on all income derived from California sources, but income derived from non-California sources is apportioned based on the percentage of trustees that are California residents. Cal. Code Regs. § 17743.

The "Paula Trust" had two trustees, one who resided in California and another who did not, and a sole California resident beneficiary. When the trust recognized a capital gain that included California-sourced income, the trustees took the position that only one-half of such gain income was subject to California income tax because one trustee was a California resident and the other was not. In 2018, the trustees won at the trial court level. The trial court agreed with the trustees' reading of the statute (Cal. Rev. & Tax. Cd. § 17743) as allowing the trust to apportion all income based on the trustees' residence, regardless of whether the income is derived from California. On appeal, the California Court of Appeal disagreed and concluded that the plain statutory language requires taxation on all California-sourced income, regardless of the residence of the trustees. In so ruling, the court upheld the FTB's regulation which provided for apportionment only of non-California source income.

For additional information, please visit www.saltsavvy.com.

By: Mike Shaikh, Palo Alto / Los Angeles

Canada Emergency Wage Subsidy (CEWS) Extension

On July 17, 2020, the Canadian government announced the proposed extension of the Canada Emergency Wage Subsidy until December 19, 2020, and provided details regarding proposed changes to the program for claim periods between July 5, 2020 and November 21, 2020. The proposed changes may reduce the subsidy amount available to certain employers, but would result in some level of assistance being available to a broader range of employers.

The proposed changes contemplate (i) a base subsidy for all eligible employers experiencing a decline in revenue (of any amount), at a rate that would vary depending on the scale of the revenue decline, and that would be gradually reduced as the program winds down, and (ii) a top up subsidy at an additional rate of up to 25% for eligible employers experiencing a revenue decline of more than 50%. A "safe harbour" rule would be available for claim periods between July 5, 2020 and August 29, 2020, so that employers would generally be eligible for a subsidy rate at least as generous as under the old rules. Additional details regarding the proposed changes can be found on Baker McKenzie InsightPlus, "*Canada Emergency Wage Subsidy (CEWS) Extension*."

The proposed extension and changes have not yet been enacted into law, but are anticipated to be shortly.

By: Stephanie Dewey, Toronto

DAC6 Update

Following the European Commission's recent proposals to defer the reporting deadlines under the new DAC6 mandatory disclosure regime, the European Council formally amended the Directive on June 24, 2020 to allow Member States the option to defer reporting deadlines by up to six months. As the deferment is optional, intermediaries and taxpayers may have to deal with a range of different reporting deadlines in the various Member States. For the first reporting period (reportable transactions between June 25, 2018, and June 30, 2020), reporting deadlines can range between August 31, 2020, and February 28, 2021. Reporting deadlines for reportable transactions after July 1, 2020, can range between August 1, 2020, and February 1, 2021. As the law became effective in all EU Member States on July 1 and the reporting deadlines may not be deferred in all relevant Member States, we recommend moving forward with preparations for mandatory disclosure. At the time of this newsletter, is has been confirmed that Finland will not be deferring the reporting deadlines, whereas the Belgium, Croatia, the Czech Republic, Denmark, Hungary, Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Romania, Slovenia Sweden and the UK have confirmed a six month deferral. Germany has

www.bakermckenzie.com

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

expressed it may not defer the deadlines, but this has yet to be confirmed. A few Member States have yet to confirm whether they opt for a deferral. Furthermore, various Member States are publishing extended guidance on DAC6. Our European offices continue to provide alerts regarding the developments. See "*United Kingdom: DAC 6 - UK opts for delay to reporting and publishes guidance*," and "*The Netherlands publishes much needed guidance on DAC6*."

By: Mounia Benabdallah, New York and Megan Ruigrok, Chicago

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