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In This Issue:

Update on the IRS's Office of Appeals

It's full steam ahead with the IRS's Office of Appeals ("Appeals") initiative (the "Appeals Initiative") to allow Exam Teams to participate in the "non-settlement portion of the Appeals conferences for the largest, most complex, cases in Appeals." Back in May 2017, Appeals first formally implemented its two-year pilot program to allow Appeals Team Case Leaders ("ATCL"s) to permit Exam Teams, including members from the IRS Office of Chief Counsel ("Counsel"), to participate in Appeals conferences. Two years later, Appeals announced that the Appeals Initiative would be extended through May 1, 2020, and on September 9, 2019, Appeals released guidelines used by ATCLs to conduct conferences pursuant to the Appeals Initiative. The Appeals Initiative has received significant criticism over the years by taxpayers and their representatives because of the Appeals Initiative's potential impact on the independence of Appeals. Nevertheless, some taxpayers have found the Appeals Initiative helpful in that it allows the taxpayer and the Exam Team to narrow the issues in front of the ATCL. This article discusses: (1) the historical background of the Appeals Initiative, (2) the guidelines released by Appeals on September 9; and (3) some observations of the Appeals Initiative based on our experiences.

Background on the Appeals Initiative

The Appeals Initiative began in October 1, 2016, when section 8.6.1.4.4 of the International Revenue Manual ("IRM"), *Participation in Conferences by IRS Employees*, was revised to provide, in relevant part, that "Appeals has the discretion to invite Counsel and/or Compliance to the conference." According to the IRS, the changes to the IRM were consistent with Treas. Reg. § 601.106(c), which provides: "At any conference granted by Appeals on a nondocketed case, the district director will be represented if the Appeals official having settlement authority and the district director deem it advisable." Then, on May 1, 2017, Appeals formally implemented its two-year pilot Appeals Initiative program. It was unclear to taxpayers and their representatives what processes and procedures Appeals would follow when allowing the Exam Team to participate in Appeals conferences. On August 8, 2017, the IRS posted a series of "FAQs" that provided some guidance on the processes and procedures Appeals should use when the Exam Team is in the room. See further information regarding the IRS's FAQs at "*When Will Appeals Excuse Exam From an Appeals Conference?*

Upcoming Tax Events

Withholding and Audits: US and Abroad (Webinar)

►October 30, 2019

Women Tax Professionals Networking Reception

Palo Alto
►November 5, 2019

TEI Austin Tax Workshop

Austin, TX
►November 18, 2019

Seventh Annual Global Tax Symposium

Houston, Texas
►December 5, 2019

2021 Platform Laws for VAT in EU and Wider Platform Developments at OECD (Webinar)

►December 10, 2019

42nd Annual North America Tax Conference

►January 30, 2020

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

Who Knows," Baker McKenzie North America Tax News and Developments, Volume XVII, Issue 9, October 2017.

Over the next two years, Appeals and the IRS responded to significant criticism from several tax practitioners about the implications of the Appeals Initiative. For example, in its 2017 Annual Report to Congress released in January 2018, the National Taxpayer Advocate, who assists taxpayers in resolving problems with the IRS and recommends changes in the administrative practices at the IRS, stated that the participation of the Exam Team and Counsel at Appeals conferences was one of the "most significant problems" for the year. Then, in March 2018, at a Federal Bar Association Section on Taxation conference, Appeals Chief Donna Hansberry defended the Appeals Initiative from criticism by practitioners. In June 2018, in response to practitioner criticism, Reinhard Schmuck, Appeals program manager, stated that Appeals was considering sending a survey to participants in the Appeals Initiative, which ideally would have allowed practitioners to formally voice their concerns about the Appeals Initiative. For the next year, however, practitioners were still waiting to see the surveys. It was not until recently on September 25, 2019, that, according to the IRS, surveys soliciting comments from participants in the Appeals Initiative had been sent out.

Finally, on May 10, 2019, at the Administrative Practice section of the American Bar Association Section on Taxation meeting, deputy chief of Appeals, Andrew Keyso Jr., announced that the program would be extended for another year through May 1, 2020. Keyso mentioned that some taxpayers had begun to embrace the Appeals Initiative and criticism had dissipated. Keyso further stated that ATCLs had found the Appeals Initiative informative because it allowed ATCLs to ask questions of both sides and narrow the issues and the dispute accordingly.

Newly Released Guidelines

On September 9, 2019, Appeals released guidelines used by ATCLs to conduct conferences pursuant to the Appeals Initiative. Included in the guidelines are three exhibits: (1) Exhibit 1: Processes and Procedures; (2) Exhibit 2: Sample Agenda for Expectations Call; and (3) Exhibit 3: Expectations Letter to Taxpayer and/or their Representative.

Exhibit 1 provides processes and procedures that the ATCLs are to use in planning and controlling the case throughout the Appeals Initiative. Among the ATCL's responsibilities are: (a) organizing an Appeals team; (b) holding an "Expectations Conference Call" with the taxpayer and the Exam Team; (c) providing upfront questions to the parties; (d) requiring the parties to provide any new arguments or information no later than 45 days prior to the opening conference; (e) narrowing the factual and legal differences; and (f) maintaining ongoing communications. According to Exhibit 1, the Exam Team will be excused after both parties have made their opening presentations and the

ATCL's questions have been adequately addressed. Once the Exam Team is excused, settlement negotiations begin between the ATCL and the taxpayer.

Exhibit 2 provides a sample agenda for the Expectations Conference Call. The agenda includes: (a) an explanation of the purpose of the meeting; (b) a discussion of the Appeals Initiative; (c) a review of the issues that will be addressed; (d) setting expectations and a vision for the conferences; and (e) a discussion of other administrative matters. Finally, Exhibit 3 provides a template of the "Expectations Letter" that taxpayers and/or their representatives should expect to receive after the Expectations Conference Call. The Expectations Letter restates many of the same processes and procedures that are listed in Exhibit 1 and should have been discussed during the Expectations Conference Call.

Comments about the guidelines will be accepted by the IRS through November 8, 2019. All comments should be sent to: Internal Revenue Service, Appeals HQ NC Room 717, 1111 Constitution Ave NW, Washington, D.C. 20224.

Program Receives Mixed Reviews

Reviews of the Appeals Initiative have been mixed. On the one hand, the program can encourage the Exam Team to take a harder look at their position. Rather than write up an adjustment and "throw it over the wall" to Appeals, Exam must now own their position. By bringing the Exam Team to the table, the Appeals Initiative forces Exam to defend their case in front of Appeals. For example, in a recent case involving a panoply of anti-abuse regulations aimed at disregarding a restructuring, the Appeals Initiative led to a full concession by Exam after facing the weaknesses of their position. The Appeals Initiative also can facilitate a dialogue between both sides. In another recent case, this one in post-docketed Appeals, the Appeals Initiative led to a favorable settlement for the taxpayer in a case with significant hazards. Although both sides wanted to avoid trial, Counsel had refused to engage in a substantive dialogue about the hazards of the Service's position. During the Appeals Initiative, however, the Appeals Officer acknowledged those hazards and encouraged Counsel to move on his position, which he ultimately did.

On the other hand, a bold Exam Team can delay negotiations by filibustering, requiring the ATCL to shut down the Exam Team. Appeals is aware of other critiques the program has received, and has already implemented informal suggestions, such as creating guidelines for Appeals team case leaders to conduct conferences. Additionally, the IRS has begun sending surveys soliciting feedback from Appeals Initiative participants. As more ATCLs use the Appeals Initiative, we expect Appeals will make further modifications to improve the program.

By Joshua Odintz and Mireille Oldak, Washington, DC and Cameron Reilly, Chicago

IRS Provides Helpful Guidance on Conversion from LIBOR

On October 9, 2019, the IRS published proposed regulations that address the tax consequences of the transition to the use of reference interest rates other than interbank offered rates ("IBOR"s) in loans and other financial instruments. The proposed regulations generally allow such conversions to proceed on a tax-free basis, although care must be taken to make sure that the rate substituted for the IBOR is a "qualified rate."

On July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing the London interbank offered rate ("LIBOR"), announced that all currency and term variants of LIBOR, including U.S.-dollar LIBOR ("USD LIBOR"), may be phased out after the end of 2021. In light of the prevalence of USD LIBOR as the reference rate in a broad range of financial instruments, the probable elimination of USD LIBOR has created risks that pose a potential threat to the safety and soundness of not only individual financial institutions, but also to financial stability generally. On March 5, 2018, the Alternative Reference Rates Committee ("ARRC"), which was comprised of the relevant governmental entities in the United States, published a report that summarizes the work done earlier to select the Secured Overnight Financing Rate ("SOFR") as the replacement for USD LIBOR.

The potential tax consequences of this change were immediately recognized. Earlier in 2019, ARRC submitted to the Treasury Department and the IRS documents that identify various potential tax issues associated with the elimination of IBORs and request tax guidance to address those issues and to facilitate an orderly transition (i.e. ARRC letters). The ARRC stated that existing debt instruments and derivatives providing for IBOR-based payments must be amended to address the coming elimination of IBORs. The ARRC indicated that these amendments will likely take one of two forms. First, the parties may alter the instruments to replace the IBOR-referencing rate with another rate, such as one based on SOFR. Second, the parties may alter the instruments to replace an IBOR-referencing fallback rate with another fallback rate upon the discontinuance of the IBOR or at some other appropriate time.

There were at least seven tax problems raised this change:

1. **<u>Modification of Debt Instruments</u>**. In the case of a debt instrument, Treas. Reg. § 1.1001–3(b) provides that a significant modification of the debt instrument results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent for purposes of Treas. Reg. § 1.1001–1(a). Under Treas. Reg. § 1.1001–3(c), a modification is generally any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument. Consequently, changing the interest rate index referenced in a

U.S. dollar de nominated debt instrument from USD LIBOR to SOFR if no provision has been made in the terms of the debt instrument for such a change is an alteration of the terms of the debt instrument that could be treated as a significant modification and result in a tax realization event, even when USD LIBOR no longer exists.

2. **Integrated Transactions and Hedges**. Amending an IBOR-referencing debt instrument or hedge to address the elimination of the IBOR may cause a deemed termination or legging out of the integrated hedge that in effect dissolves the integrated instrument into its component parts, which may yield undesirable tax consequences or recognition events for the parties to those instruments.

3. **Source and Character of One-Time Payments**. The ARRC letters pointed out that, when parties alter the terms of a debt instrument or modify the terms of a non-debt contract to replace a rate referencing an IBOR, the alteration or modification may consist not only of the replacement of the IBOR with a new reference rate such as SOFR but also of an adjustment to the existing spread to account for the differences between the IBOR and the new reference rate. Alternatively, in lieu of (or in addition to) an adjustment to the spread, the parties may agree to a one-time payment as compensation for any reduction in payments attributable to the differences between the IBOR and the new reference rate. In the latter case, questions arise about the source and character of this one-time payment for various purposes of the Internal Revenue Code, such as the withholding rules in sections 1441 and 1442.

4. **Grandfathered Instruments**. The requirements of certain statutes and regulations do not apply to debt instruments and non-debt contracts issued before a specific date. If a debt instrument is altered or a non-debt contract is modified to replace an IBOR referencing rate in anticipation of the elimination of the IBOR, the debt instrument or non-debt contract may be treated as reissued as a consequence of the alteration or modification and therefore subject to the statute or regulation from which it was previously exempt.

5. **Original Issue Discount**. The transition to alternative rates, such as SOFR, in connection with the phase-out of IBORs has raised questions under the OID rules. For example, it is not clear whether certain debt instruments that reference IBOR qualify as variable rate debt instruments or whether they are subject to non-remote contingencies that must be taken into account.

6. **REMICs**. Section 860G(a)(1) provides in part that a regular interest in a REMIC must be issued on the startup day with fixed terms. Treas. Reg. Section 1.860G–1(a)(4) clarifies that a regular interest has fixed terms on the startup day if, on the startup day, the REMIC's organizational documents irrevocably specify, among other things, the interest rate or rates used to compute any interest payments on the regular interest. Accordingly, an alteration of the terms of the regular interest to change the rate or fallback provisions in anticipation of the cessation of an IBOR could preclude the interest from being a regular interest.

7. **Interest Expense of a Foreign Corporation**. Treas. Reg. § 1.882– 5(d)(5)(ii)(B) provides that a foreign corporation that is a bank, may elect to use a published average 30-day LIBOR for the year instead of determining its average U.S.-dollar borrowing cost. Because the election provided in Treas. Reg. § 1.882–5(d)(5)(ii)(B) only permits a foreign corporation that is a bank to elect a rate that references 30-day LIBOR, the current election will not be available when LIBOR is phased out.

The Proposed Regulations

The proposed regulations address each of these questions, and generally provide favorable guidance.

1. **Modification of Debt Instruments**. The proposed regulations under Prop. Reg. § 1.1001–6(a) generally provide that, if the terms of a debt instrument are altered or the terms of a non-debt contract, such as a derivative, are modified to replace, or to provide a fallback to, an IBOR-referencing rate and the alteration or modification does not change the fair market value of the debt instrument or non-debt contract or the currency of the reference rate, the alteration or modification does not result in the realization of income, deduction, gain, or loss for purposes of section 1001. The proposed rules in Prop. Reg. § 1.1001–6(a) also apply regardless of whether the alteration or modification occurs by an amendment to the terms of the debt instrument or non-debt contract or by an exchange of a new debt instrument or non-debt contract for the existing one.

Section 1.1001–6(a)(1) of the proposed regulations provides that altering the terms of a debt instrument to replace a rate referencing an IBOR with a "qualified rate" is not treated as a modification and therefore does not result in a deemed exchange of the debt instrument for purposes of Treas. Reg. § 1.1001–3. This same rule applies to ''associated alterations,'' which are alterations that are both associated with the replacement of the IBOR-referencing rate and reasonably necessary to adopt or implement that replacement. One example of an associated alteration is the addition of an obligation for one party to make a one-time payment in connection with the replacement of the IBOR-referencing rate with a qualified rate to offset the change in value of the debt instrument that results from that replacement.

One of the more important aspects of the proposed regulations is that they delineate what floating rates will be treated as a "qualified rate." The most significant ones are as follows:

(i) The Secured Overnight Financing Rate published by the Federal Reserve Bank of New York ("SOFR");

(ii) The Sterling Overnight Index Average ("SONIA");

(iii) The Tokyo Overnight Average Rate ("TONAR" or "TONA");

(iv) The Swiss Average Rate Overnight ("SARON");

(v) The Canadian Overnight Repo Rate Average ("CORRA");

(vi) The Hong Kong Dollar Overnight Index ("HONIA");

(vii) The interbank overnight cash rate administered by the Reserve Bank of Australia ("RBA Cash Rate");

(viii) The euro short-term rate administered by the European Central Bank ("ÖSTR");

(ix) Any alternative, substitute or successor rate selected, endorsed or recommended by the central bank, reserve bank, monetary authority or similar institution (including any committee or working group thereof) as a replacement for an IBOR or its local currency equivalent in that jurisdiction.

A rate is only a "qualified rate" if the fair market value (generally defined as the price at which the instrument would change hands between a willing buyer and willing seller) of the "new" instrument is substantially equivalent to the fair market value of the "old" instrument (the "fair market value equivalence test"). The fair market value may be difficult to determine precisely, and therefore the fair market value may generally be determine by any reasonable value method. The proposed regulations do not provide how close in value the "old" and "new" instrument must be in order to have a "substantially equivalent" value. The proposed regulations, do, however, provide for two safe harbors which if either are met, result in the fair market value equivalence test being satisfied.

The first safe harbor (the "historic average safe harbor") provides that if the historical average of the relevant IBOR rate and the historical average of the replace rate do not differ by greater than 25 basis points (after taking into account any spread, on-time payments, or other adjustments made in connection with the alteration), then the fair market value equivalence test is deemed to be satisfied.

2. **Integrated Transactions and Hedges**. Section 1.1001–6(c) of the proposed regulations confirms that a taxpayer is permitted to alter the terms of a debt instrument or modify one or more of the other components of an integrated or hedged transaction to replace a rate referencing an IBOR with a qualified rate without affecting the tax treatment of either the underlying transaction or the hedge, provided that the integrated or hedged transaction as modified continues to qualify for integration. For example, a taxpayer that has issued a floating rate debt instrument that pays interest at a rate referencing USD LIBOR and has entered into an interest rate swap contract that permits that taxpayer to create a synthetic fixed rate debt instrument under the integration rules of Treas. Reg. § 1.1275–6 is not treated as legging out of the integrated transaction if the terms of the debt instrument are altered and the swap is modified to replace the USD LIBOR-referencing interest rate with a SOFR-referencing interest rate.

3. **Source and Character of One-Time Payments**. Section 1.1001–6(d) of the proposed regulations provides that, for all purposes of the Internal Revenue Code, the source and character of a one-time payment that is made by a payor in connection with an alteration or modification described in proposed § 1.1001–6(a)(1), (2), or (3) will be the same as the source and character that would otherwise apply to a payment made by the payor with respect to the debt instrument or non-debt contract that is altered or modified. For example, a one-time payment made by a counterparty to an interest rate swap is treated as a payment with respect to the leg of the swap on which the counterparty making the one-time payment is obligated to perform. Accordingly, under Prop. Reg. § 1.863–7(b), the source of that one-time payment would likely be determined by reference to the residence of the recipient of the payment. With respect to a lease of real property, a one-time payment made by the lessee to the lessor is treated as a payment of rent and, under sections 861(a)(4) and 862(a)(4), the source of that one-time payment would be the location of the leased real property.

4. **Grandfathered Instruments**. The rules in § 1.1001–6(a) of the proposed regulations generally prevent debt instruments and non-debt contracts from being treated as reissued following a deemed exchange under section 1001. Thus, for example, a debt instrument grandfathered under section 163(f), 871(m), or 1471 or a regulation under one of those sections would not lose its grandfathered status as a result of any alterations made in connection with the elimination of an IBOR.

5. **Original Issue Discount**. The proposed regulations generally provide that a VRDI is not treated as retired and reissued when the relevant IBOR becomes unavailable or unreliable.

6. **<u>REMICs.</u>** Section 1.860G–1(e) of the proposed regulations permits an interest in a REMIC to retain its status as a regular interest despite certain alterations and contingencies. Specifically, if the parties to a regular interest alter the terms after the startup day to replace an IBOR-referencing rate with a qualified rate, to include a qualified rate as a fallback or to an IBOR-referencing rate.

7. **<u>Interest Expense of a Foreign Corporation</u>**. Because the election provided in Treas. Reg. § 1.882–5(d)(5)(ii)(B) only permits a foreign corporation that is a bank to elect a rate that references 30-day LIBOR, the current election will not be available when LIBOR is phased out. To address this change in facts, the proposed regulations amend the election to allow a foreign corporation that is a bank to compute interest expense attributable to excess U.S.-connected liabilities using a yearly average SOFR.

Comments

The proposed regulations provide much-needed relief to the potential tax consequences of the elimination of LIBOR. The proposed regulations are relatively flexible in allowing parties to replace an IBOR with a "qualified rate" so long as the fair market values of the pre- and post-change instruments are substantially the same. These changes will be relatively easy to adopt in the context of one-to-one transactions, whether bank loans or derivatives. However, the rules will be harder to apply in the context of publicly-traded instruments since it is not completely clear how fair market value will be determined if there are multiple holders who may place differing values on the instruments involved.

Even though there are open questions, the proposed regulations are certainly a good first step in providing clarification concerning the tax consequences of the elimination of LIBOR.

By Richard Lipton, Chicago, Karl Egbert, New York,
Steven Schneider, Washington, DC

OECD Statistics Show New MAP Cases (and Audits) on the Rise

On September 16, 2019, the Organisation for Economic Co-operation and Development ("OECD") released the Mutual Agreement Procedure ("MAP") statistics for 2018 ("MAP Statistics"). The 2018 MAP Statistics stem from Base Erosion and Profit Shifting ("BEPS") Action 14, which seeks to improve the resolution of tax-related disputes between jurisdictions.

The MAP Statistics cover 89 jurisdictions and nearly all MAP cases worldwide, and include information on opening and closing case inventory, evolution of case inventory, types of outcomes for cases closed, average time for cases closed, and closing case ratios. The MAP Statistics are reported in total cases and by case type – either transfer pricing cases (i.e., attribution of profits to a permanent establishment or determination of profits between associated enterprises under Articles 7 and 9 of the OECD Model Tax Convention, respectively) or other cases (i.e., all cases that do not involve transfer pricing).

Inherent in the MAP Statistics is a rise in audits in 2018, and taxpayers are seeking relief through the MAP process.

Caseload

Although more MAP cases were closed in 2018 than in 2017, the number of new MAP cases increased. Transfer pricing cases increased by nearly 20% while other cases increased by more than 10%. The following table shows the jurisdictions with the most cases started in 2018:

Total Cases Started		**Transfer Pricing Cases Started**		**Other Cases Started**	
Jurisdiction	**#**	**Jurisdiction**	**#**	**Jurisdiction**	**#**
Germany	615	France	222	Belgium	546
Belgium	581	Italy	196	Germany	437
France	449	Germany	178	Netherlands	293
Netherlands	357	United States	157	France	227
Italy	256	India	133	Luxembourg	227

In North America, the United States started 253 total cases, 157 transfer pricing cases, and 96 other cases; Canada started 97 total cases, 75 transfer pricing cases, and 22 other cases; and Mexico started 19 total cases, 12 transfer pricing cases, and 7 other cases.

The following table shows the jurisdictions with the most cases closed in 2018:

Total Cases Closed		Transfer Pricing Cases Closed		Other Cases Closed	
Jurisdiction	**#**	**Jurisdiction**	**#**	**Jurisdiction**	**#**
Germany	658	Germany	227	Belgium	596
Belgium	635	United States	181	Germany	431
Netherlands	373	France	136	Netherlands	314
France	362	Canada	102	Luxembourg	241
United Kingdom	274	Italy	90	France	226

In North America, the United States closed 251 total cases, 181 transfer pricing cases, and 70 other cases; Canada closed 126 total cases, 102 transfer pricing cases, and 24 other cases; and Mexico closed 7 total cases, 6 transfer pricing cases, and 1 other case.

Similar to 2017, Germany, Belgium, and France were near the top of the pack in both total cases started and total cases closed. In the Netherlands, the total cases started increased from 223 to 357 and total cases closed from 176 to 373 in 2018, representing increases of 60% and 112%, respectively. Another noteworthy jurisdiction is Spain, which had a significant increase in total cases started from 112 to 211 that largely can be attributed to a near tripling of transfer prices cases started.

Of the total MAP cases closed in 2018, 80% were successfully resolved (at least in part), which is a small improvement from 79% in 2017.

Time to Close Cases

The average time to close transfer pricing cases increased by 3 months, from 30 months to 33 months, between 2017 and 2018. Meanwhile, the average time to close non-transfer pricing cases decreased by 3 months, from 17 months to 14 months, during the same period. In the United States, the average time to close MAP cases for 2016 through 2018 is as follows (in months):

Case Type	2016	2017	2018
Transfer Pricing Cases	31.61	24.43	34.98
Other Cases	28.65	26.02	32.78
All Cases	30.99	24.78	34.37

As shown above, the United States made significant progress in decreasing its average time to close cases in 2017, only to have that headway reversed in 2018. This comes on the heels of recent criticism by the OECD of the MAP processing times for the United States in the MAP Peer Review Report (Stage 2), which exceeded the Action 14 target of 24 months. In that report, the OECD said that the United States should “make more adequate use of the available resources in order to be able to resolve MAP cases in a timely, efficient, and effective manner” and that “further resources may be necessary.” However, the increase in time to close cases could signal that the United States cleared out older MAP inventory.

Implications

One thing is clear from the MAP Statistics, which is that taxpayers are facing increased audits and are investing resources in the MAP process, as shown by the spike in the number of new cases. Further, the current variability in approaches to digital taxation among countries potentially exposes companies to double taxation, which may result in an even further increase in MAP cases. That said, if countries can agree on safe harbors or benchmarks for routine transactions and communicate them publicly, then many cases could be kept from the purview of MAP. Taxpayers also may want to consider alternatives to MAP for transfer pricing issues, such as advance pricing agreements (“APAs”), to proactively address potential disputes. APAs are often an efficient means of achieving transfer pricing certainty while avoiding prolonged audits.

By Donna McComber and Kent Stackhouse, Washington DC

A Day Late but No Dollars Short

On July 26th, the IRS issued three Private Letter Rulings (PLRs), 201930020, 201930022, and 201930024 granting the requesting taxpayers additional time to file for the Rev. Proc. 2011-29 safe-harbor election to treat 70% of success-based corporate transaction costs as deductible. The IRS has granted similar rulings (e.g., PLRs 201825001 and 201739003) where a taxpayer failed to comply with the safe-harbor election procedures.

While the IRS continues to grant late relief, advisers and taxpayers should take care to avoid the time and expense associated with requesting a PLR. The continued issuance of this type of PLR shows that advisers need to ensure that post-transaction filings are made timely.

Success-based Fees

Code Section 263(a) generally requires taxpayers to capitalize amounts paid for new buildings or for permanent improvements or betterments made to increase the value of property. Treas. Reg. §§ 1.263(a)-1(d)(3) and 1.263(a)-4(d)(20(i)(A) disallow a deduction for amounts paid to acquire or create an intangible, which includes an ownership interest in a corporation or entity. A taxpayer must capitalize amounts paid to facilitate the acquisition or reorganization of a business under Treas. Reg. § 1.263(a)-5.

Success-based fees are presumed to facilitate the transaction under Treas. Reg. § 1.263(a)-5(f); however, a taxpayer may, by maintaining sufficient documentation, rebut this presumption and deduct a portion of any success-based fees. The determination of what is and is not facilitative is based on all of the facts and circumstances of a given transaction. The IRS issued Rev. Proc. 2011-29, 2001-1 C.B. 746, creating a safe-harbor in order to reduce controversy between the IRS and taxpayers over the documentation and allocation of success-based fees between facilitative activities and activities that do not facilitate a transaction.

Under the safe-harbor, a taxpayer may treat 70% of the amount of success-based fees as an amount that does not facilitate the transaction, capitalizing the remaining 30% as an amount that is facilitative. The taxpayer must attach a statement to its federal income tax return for the taxable year in which the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized. The safe harbor applies to a taxable acquisition by the taxpayer of assets constituting a trade or business, a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or the target) if the acquirer and target are related after the acquisition, and certain reorganizations.

At the IRS's discretion, a taxpayer that fails to comply with the safe harbor requirements may request relief under Treas. Reg. § 301.9100-1. Generally, the taxpayer must present evidence that it acted reasonably and in good faith and that the relief requested would not prejudice the interests of the government. The regulations describe several circumstances in which a taxpayer will be deemed to have acted reasonably and in good faith. In particular, Treas. Reg. § 301.9011-1(b)(1)(i) states that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer requests relief before the failure to make the regulatory election is discovered by the IRS. Treas. Reg. § 301.9100-1(b)(1)(v) states that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

The Rulings

In all three cases, the taxpayer properly deducted 70% of the success-based fees, but did not attach the required election statement on its tax return for the tax year in which the success-based fee was paid or incurred. In PLRs 201930020 and 201930022, the taxpayer discovered the omission of the required statement after the returns had been filed for the tax year in question, but before the omission was discovered by the IRS. In PLR 201930024, the IRS discovered the omission, and disallowed the deduction for 70% of the success-based fees incurred by the taxpayer.

In all three cases, the taxpayer represented that it reasonably relied on a qualified tax professional, and the tax professional failed to make or advise the taxpayer to make the Rev. Proc. 2011-29 safe-harbor election for success-based fees it incurred in connection with a transaction the taxpayer had undertaken. The taxpayer also represented that it would not have a lower tax liability in aggregate for all taxable years affected by the election if given the permission to make the election, showing that allowing the late relief would not prejudice the interests of the government.

In connection with the PLR requests, the IRS granted 60 days to properly make its safe-harbor election for the taxpayers in PLR 201930020 and 201930022. The IRS granted 45 days in PLR 201930024.

Parting Thoughts

After a transaction, especially a large acquisition, it is quite common for a taxpayer to utilize different advisers or perhaps a new internal tax department. Simple required filings such as the Rev. Proc. 2011-29 safe-harbor statement can easily slip through the cracks when there are significant changes such as these. Recognizing this, the IRS continues to grant late relief; however, tax departments and tax advisers should work together to establish post-close procedures to avoid the scramble for a private letter ruling as late relief is at the discretion of the IRS.

By Joseph Volk, San Francisco

Revenue Procedure Finalized Creating Safe Harbor for Rental Real Estate Enterprise

On September 24, 2019, Treasury and the IRS released Revenue Procedure 2019-38 ("Rev. Proc. 2019-38") that finalized a safe harbor for rental real estate enterprises originally proposed in Notice 2019-7 on January 18, 2019, in relation to Code Section 199A. Under the safe harbor, a rental real estate enterprise will be treated as a trade or business for purposes of section 199A provided all the enumerated requirements are met. Included within Rev. Proc. 2019-38 are the following: who is eligible for the safe harbor; the definition of a rental real estate enterprise; how residential, commercial, or mixed-use should be categorized and whether they can be either a single or separate rental real estate enterprise; what constitutes rental services; what will be treated as an excluded interest; and, of course, the requirements of the safe harbor, and how to elect its application.

For a detailed discussion, please see the Baker McKenzie Client Alert, "*Revenue Procedure Finalized Creating Safe Harbor for Rental Real Estate Enterprise*," distributed on October 7, 2019, which provides an in-depth analysis of the safe harbor and the requirements that must be satisfied in order for a rental real property enterprise to qualify. The analysis generally follows that of Rev. Proc. 2019-38, and is followed by Baker McKenzie's observations and key takeaways, especially vis-à-vis the proposed safe harbor published in Notice 2019-7.

By Daniel Hudson, Miami

Russian Tax Residence Status in Only 90 Days

New rules announced recently will treat individuals as Russian tax residents if their center of vital interests is in Russia regardless of the number of days spent there. The main target of the rules are high net worth Russian individuals who have moved abroad or ceased to be Russian tax residents but have kept close ties with Russia and have Russian businesses and assets. However, this may lead to unwanted residency status in some cases while in others allow taxpayers to claim tax treaty benefits among the jurisdictions with a tax treaty with Russia. Often newly created or existing US or UK entities and/or business are involved for example, raising questions on the application of the corresponding tax treaty. Another complication is the automatic exchange of information with Russia by foreign banks and other financial institutions – with more than one tax residence, over-reporting may happen and result in costly and lengthy tax audits requiring proper evidence and explanations. Finally, the possibility in global non-taxation and residence nowhere is practically eliminated, requiring proper tax planning and continued monitoring of tax compliance and changing tax rules.

For a detailed discussion, please see the Baker McKenzie Client Alert, "*Russian Tax Residence Status in only 90 Days*," distributed in October 2019.

By Lyubomir (Lubo) Georgiev, Zurich

States Over the Edge and Testing Boundaries with Business Activity Tax Nexus Guidance

Three states, Pennsylvania, Texas, and Wisconsin, have recently issued guidance regarding business activity tax nexus. On September 30, Pennsylvania issued Bulletin No. 2019-04 proclaiming an economic nexus threshold for purposes of determining whether corporate taxpayers are subject to its corporate net income tax ("CNIT"), effective January 1, 2020. In August, the Texas Comptroller issued proposed amendments to Administrative Code section 3.586 that are similar to Pennsylvania's guidance, also effective January 1, 2020. Both states adopted a $500,000 bright-line gross receipts threshold. Wisconsin has taken a different approach from Pennsylvania and Texas in its pre-*Wayfair* nexus clarification rules that go into effect on September 30, 2019. Instead of creating a bright-line economic nexus threshold, Wisconsin focused its update on the types of activities conducted in the state that are considered nexus-creating activities and/or to exceed the protections of P.L. 86-272.

For more information on these and other recent state and local tax updates, please see "*States over the Edge and Testing Boundaries with Business Activity Tax Nexus Guidance,*" on the SALT Savvy blog, available at www.saltsavvy.com.

By Rob Galloway, Chicago

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Getting Better All The Time…Baker McKenzie Adds New Talent to its State and Local Tax Group

Baker McKenzie is pleased to announce the arrival of Mark Yopp as a tax partner in our New York office. Mark has more than 10 years of experience in state and local tax, including tax controversy, multistate planning, and federal and multistate legislative monitoring and analysis. In his most recent role as a partner at an international law firm, Mark advised on matters related to income and franchise taxes, sales and use taxes, and withholding requirements. He has assisted clients in identifying and addressing the state and local tax implications of new and emerging technologies, including digital goods and services, cloud computing, electronic commerce, and digital marketplaces.

Mark earned his B.A. from Wake Forest University and his J.D. from Emory University School of Law. He is admitted to practice in New York.

Please join us in welcoming Mark to the North America Tax Practice Group!

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

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