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In This Issue:

Fate of TCJA Legislative Fixes Depends on Midterm Election Results

While several major regulatory packages are slated for release in the final quarter of calendar year 2018, taxpayers should also keep their eye on potential legislative developments at year-end. It is highly unlikely that the “Tax Reform 2.0” bill passed by the House will find success in the Senate, but tax items may still be included in a year-end spending bill. Though comprehensive technical corrections are unlikely, some isolated fixes could be part of the “lame duck” Congress’s annual display of momentary bipartisanship and holiday cheer before they leave for recess.

It is expected that Congress will renew the usual list of tax extenders, though it is highly unlikely that any of the sun-setting provisions of the Tax Cuts and Job Act (“TCJA”) will be taken up in the year-end package. However, there are certain isolated fixes to the TCJA that appear to have enough support to be added to this year’s wish list. The first is the effective date glitch in the net operating loss (“NOL”) provisions. Under prior law, NOLs could generally be carried back two years and forward for 20 years. The TCJA limits the NOL deduction to 80% of taxable income, repeals the two-year carry-back, and allows for unlimited carry-forward.

The text of the statute and the Conference Report state that the 80% limitation applies to losses “arising in taxable years beginning after December 31, 2017.” However, the effective date for the modification to carry-backs and carry-forwards differs in the statute and in the Conference Report. The statute states that the amendment applies to NOLS arising in taxable years *ending* after December 31, 2017, while the Conference report states that it applies to NOLs arising in taxable years *beginning* after December 31, 2017. Absent other guidance, the statutory language controls, creating a mismatch between the 80% limitation and the ability to carry NOLs to another taxable year. There is general consensus on Capitol Hill that the Conference report accurately describes Congressional intent, as well as a bipartisan willingness to correct the statutory language.

Another provision likely to be included in year-end legislation is the treatment of Qualified Improvement Property (“QIP”) for purposes of temporary, full and immediate expensing under section 168(k). The TCJA consolidated the definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property into a single definition of “QIP,” but the text of the statute omitted the new, unified category of QIP from the list of 15-year property eligible for expensing under section 168(k) (the three consolidated categories had all been treated as 15-year property). The legislative history makes clear that Congress intended to include QIP on the list of 15-year property, thus making QIP eligible for immediate expensing. Despite requests from affected taxpayers and letters received from members of Congress explaining that they intended to include QIP on the list of 15-year property,

Upcoming Tax Events

Hard Brexit: The VAT & Customs Implications

Webinar
► November 5, 2018

Sixth Annual TEI Austin - Baker McKenzie Tax Workshop

Austin, TX
► November 9, 2018

Sixth Annual TEI Houston Tax Symposium

Houston, TX
► December 4, 2018

41st Annual North America Tax Conference

Mexico City, Mexico
► January 31, 2019

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Treasury did not fix the glitch in proposed regulations released this summer. Due to the far-reaching impact of this error, Congress' clear intent in the legislative history, and support from both sides of the aisle, it is likely that this provision will be fixed during the lame duck period.

Though passage of these two fixes is already likely, due to their obvious technical nature, several key members of the tax writing committees are retiring and may be especially eager to fix any perceived errors in the TCJA. In particular, Senator Orrin Hatch (R-UT), Chairman of the Senate Finance Committee, and Rep. Paul Ryan (R-WI), Speaker of the House and former Chairman of the House Ways and Means Committee, are both retiring this year. Both were integral to passage of the TCJA, and will likely be sympathetic to any fixes that can solidify their legacies. Several Republican members of the House Ways and Means Committee are also retiring or leaving their positions for other offices, including Sam Johnson (R-TX), Dave Reichert (R-WA), Lynn Jenkins (R-KS), Diane Black (R-TN), Jim Renacci (R-OH), and Kristi Noem (R-SD).

The long-term fate of the TCJA is highly dependent on the outcome of the midterm elections. Current projections generally show that the Democrats will pick up seats in this Fall' s elections. However, speculation abounds as to whether Democrats will flip either or both houses of Congress. Because all of the members in the House of Representatives are up for reelection this year, the Democrats have a better chance of taking control of the House than the Senate, where only a third of the members – mostly in strong or leaning Republican states – are up for reelection. It is unclear where modifying the TCJA would rank on the Democrats' list of priorities if they won control of the House. Even if Democrats take control of the House, bipartisanship will be required in the Senate to pass additional tax legislation because the 60-vote threshold applies and neither party is expected to win a 60-vote majority. Current Minority Leader Chuck Schumer (D-NY) has expressed interest in bipartisan tax reform, has a history of working across the aisle (with Senator Portman) and across the houses (with Speaker Ryan) on tax legislation, and has been active in studying the international provisions of the Code. In general, the Democrats have been meeting with taxpayers to understand the impact of the TCJA's various provisions and considering what legislative changes they would propose if given the opportunity. At least some Democratic members' offices have been candid in expressing their concerns about the TCJA's impact on the deficit, and have noted that the corporate income tax rate may need to be raised to maintain revenue projections if other provisions in the TCJA (such as the BEAT) are revised.

If Republicans retain control of the House and Senate, it is likely that they will be open to revisiting the TCJA to make additional, and more taxpayer-friendly, modifications than can be passed in the lame duck session. Rep. Kevin Brady (R-TX), the Chairman of the House Ways and Means Committee, has already made clear that he did not view the TCJA as the last word on international tax reform and we understand that, should Rep. Brady retain his Chairmanship, amending the international provisions will be a legislative priority.

Taxpayers currently pursuing a legislative strategy to address their concerns with the TCJA should be prepared to revisit that strategy on November 7th, and revise it if necessary.

By Alexandra Minkovich* and *Kathryn Rimpfel, Washington, DC

Rettig Confirmed as IRS Commissioner

On Wednesday, September 12, 2018, Charles "Chuck" Rettig was confirmed as the IRS Commissioner by a 64-33 vote in the Senate. He succeeds David Kautter, who has served as interim Commissioner since November 2017. Kautter will continue to serve as a top tax policy advisor to the US Treasury.

From the standpoint of the tax bar, possibly the most significant point of this appointment is that unlike his most recent predecessors, Rettig has spent the vast majority of his career as a tax lawyer in private practice, focusing primarily on representing taxpayers in disputes with the IRS. Rettig previously served as the Chair of the IRS Advisory Council, which makes recommendations on IRS policies. He is a former chair of the California Bar's tax section, and served as the vice-chair on administration for the American Bar Association's tax section and vice-president of the American College of Tax Counsel.

President Trump nominated Commissioner Rettig in February 2018, and his confirmation hearing was held in June. The Senate Finance Committee voted to advance his nomination in July by a narrow margin of 14-13. Senate Democrats believe he is qualified, but voted against his nomination in July as a protest against guidance announced by the US Treasury on July 16 lifting donor disclosure requirements on some tax-exempt groups.

Rettig faces the first tax season under the sweeping reforms of the Tax Cuts and Jobs Act ("TCJA") with limited IRS resources, as staff levels have dipped notably over the past five years due to funding cuts. Congress did increase IRS funding in March 2018 with a $320 million short-term allocation (passed as part of a larger general omnibus package) to assist the IRS in implementing the Tax Cuts and Jobs Act. Kautter had originally requested $397 million over two years to implement the TCJA, and an independent official within the IRS, the national taxpayer advocate, had estimated that the IRS would need $495 million over two years to implement the TCJA, so it remains to be seen whether additional implementation funding could be forthcoming in 2019. The IRS's overall budget is $11.4 billion for the next fiscal year, but this number is still lower than the 2010 figure of $12.1 billion (for a year that did not involve implementing a landmark tax reform package).

Other challenges Rettig faces include questions from Democrats about Trump's tax returns, which were not released during the 2016 elections, and the modernization of the IRS's technology systems in the wake of a system crash on Tax Day 2018 that affected millions of taxpayers attempting to file returns online.

Commissioner Rettig's term extends through 2022. For further details, please see www.irs.gov.

By Grace Meador, San Francisco

CAP Program Continues, IRS Announces Changes

On August 27, 2018, the IRS announced the continuation of its Compliance Assurance Process ("CAP") program for 2019, subject to certain modifications. IR-2018-174. CAP began in 2005, as a cooperative pre-filing program for large taxpayers, specifically companies under the jurisdiction of the IRS's Large Business & International ("LB&I") Division, with assets of $10 million or more, and meet certain other requirements.

CAP replaces the traditional examination process and is intended to reduce the taxpayer's burden through the contemporaneous exchange of information about events and transactions. CAP is intended to resolve issues prior to filing a return providing tax certainty sooner, decrease overall audit cycle time, and provide resource and time savings for the taxpayer.

CAP is divided into three stages, and taxpayer progress through each stage:

(1) **Pre-CAP**: taxpayer works with the IRS to resolve filed years with the goal of meeting the CAP selection criteria and getting on a real-time schedule;

(2) **CAP**: taxpayer works collaboratively and transparently to resolve material tax positions before they are filed on the return; and

(3) **CAP Maintenance**: for taxpayers that have a completed two full CAP audit cycles, maintained professional relationships with open, honest communication with the CAP team, and have fewer complex issues.

Since the CAP program began in 2005 it has grown from 17 taxpayers to 169 taxpayers. While the CAP program expands, the LB&I division of the IRS responsible for the program has declined by more than 25 percent. The IRS announcement of changes to the CAP program are in part an attempt to improve the operation of the program and ensure the efficient use of limited resources.

Changes for the 2019 CAP Program

The following summarizes the key changes to the CAP program announced by the IRS for the 2019 year. For 2019, the CAP program is limited to current participants.

(1) The application period for 2019 has shifted to open on October 1, 2018 and close on November 30, 2018. CAP remains limited to existing CAP taxpayers who meet eligibility requirements.

(2) Applications must include a preliminary list of materials issues for the year, including specified transfer pricing issue information and research credit information. This list will be used to determine issues reviewed and resources allocated during the CAP audit.

(3) LB&I will establish a 90-day goal for issue resolution. All disagreements will be sent to Appeals on a "timelier basis to encourage quick resolution

of issues." Certain transfer pricing issues may be required to be resolved via the Advance Pricing Agreement program.

(4) Taxpayers must provide a representation letter within 30 days of filing the return (representing that it took the agreed-to positions on the return) and timeframes will be implemented for IRS post-file review.

(5) CAP Maintenance will be modified so "lowest risk" taxpayers may continue in the program without IRS review of a particular year.

(6) LB&I will allocate resources to the CAP program as part of annual planning, and this planning may determine the number of taxpayers in the program and/or whether all issues can be addressed.

Changes Anticipated For the Future

In addition to immediate changes listed above for the 2019 year, the IRS has indicated that additional modifications to the CAP program may be appropriate in the future. In particular the IRS has highlighted the following changes for the future:

(1) The CAP program will be open to additional taxpayers who meet eligibility criteria and program requirements.

(2) Taxpayer will be required to provide certification of a tax control framework.

(3) Issue-based resolutions may be appropriate as the program is expanded.

Observations

The IRS announcement extending the CAP program is good news for taxpayers currently in CAP and those seeking entrance into CAP. The IRS focus on transfer pricing issues as the subject of several of the modifications is notable and acknowledges IRS's concern related to these resource-intensive matters. The ability to stay in CAP Maintenance and receive the benefits of CAP, such as certainty related to the return, without IRS review for a particular year signals an IRS appreciation for those taxpayer in CAP with good track records. For taxpayers desiring more certainty with respect to reporting, CAP promotes better management of tax reserves and more precise reporting of earnings and financial statements. Taxpayers not yet in the program may be able to apply in years subsequent to 2019. Overall the changes are reflective of the IRS acknowledging its own resource constraints and the need to adjust their approach to CAP in an environment of reduced budget and resources.

By Amanda Kottke, Palo Alto

IRS Announces Five New LB&I Campaigns

On September 10, 2018, the IRS Large Business and International division ("LB&I") announced five new compliance campaigns. These campaigns reflect

LB&I's continued focus on redefining its compliance work for large businesses and deploying resources more deliberately. This is the sixth set of announced compliance campaigns. LB&I announced its first 13 campaigns on January 31, 2017, 11 campaigns on November 3, 2017, five campaigns on March 13, 2018, six campaigns on May 21, 2018, and five more campaigns on July 2, 2018. See prior *Tax News and Developments* articles, *LB&I New Campaigns Focus on Withholding and International Individual Compliance* (June 2018) and *LB&I Announces Five Additional International Compliance Campaigns* (July 2018).

Similar to the previous campaigns, the September 10, 2018, LB&I announcement emphasizes that LB&I identified the five new campaigns through data analysis and from the suggestions of IRS employees. Specifically, the announced campaigns are:

Section 199 - Claims Risk Review

The Tax Cuts and Jobs Act of 2017 repealed the section 199 Domestic Production Activity Deduction ("DPAD") for taxable years beginning after December 31, 2017. DPAD is a deduction for companies that perform domestic manufacturing and other production activities. The IRS previously addressed section 199 in the LB&I campaigns announced on January 31, 2017. In the previous campaign, the IRS agreed to consider whether certain taxpayers were the producers of "qualified film" such that they would be eligible for DPAD.

The current campaign attends to business entities that may file a claim for more DPAD under IRC Section 199 before the deduction expires. The Section 199 Claims Risk Review campaign intends to ensure taxpayer compliance with section 199 through a claim risk review assessment and issue-based examinations. In issue-based examinations, LB&I identifies a particular area of business or international tax law that presents compliance challenges and focuses its analysis on returns that contain that particular issue.

Syndicated Conservation Easement Transactions

Notice 2017-10 designates specific syndicated conservation easement transactions as listed transactions and requires disclosure statements by both investors and material advisors for these transactions. The syndicated conservation easement transaction campaign intends to encourage taxpayer compliance and guarantee consistent treatment of taxpayers in similar positions by ensuring that easement contributions meet the legal requirements for a deduction and that the fair market values are accurate.

Issue-based examinations are the first treatment stream. Other streams will be considered as the campaign develops.

Foreign Base Company Sales Income: Manufacturing Branch Rules

The Manufacturing Branch Rules campaign intends to identify and select for examination returns of US shareholders of controlled foreign corporations ("CFCs") that may have underreported subpart F income based on certain interpretations of the manufacturing branch rules.

Generally, when a CFC has income derived from the sale of personal property manufactured by the CFC, this income is not included in foreign base company sales income ("FBCSI"). However, if a CFC manufactures property through a branch outside of its country of incorporation, the manufacturing branch may be treated as a separate, wholly-owned subsidiary of the CFC for purposes of computing the CFC's FBCSI. As a result, the US shareholder(s) of the CFC may recognize a subpart F inclusion with respect to such amounts.

The Manufacturing Branch Rules campaign will use issue-based examinations as its treatment stream.

1120F Interest Expense/Home Office Expense

The 1120F Interest/Home Office Expense campaign addresses deductions claimed under (1) Treas. Reg. § 1.882-5 for the interest expense of a foreign corporation that is allocable to their effectively connected income, and (2) Treas. Reg. § 1.861-8 for certain Home Office expenses. This campaign intends to identify "aggressive positions" taken by taxpayers in these areas and increase taxpayer compliance with the interest expense rules and the Home Office expense allocation rules. For example, the IRS would scrutinize the use of apportionment factors that may not attribute the proper amount of expenses to the calculation of effectively connected income.

This campaign will use issue-based examinations for its treatment stream.

Individuals Employed by Foreign Governments & International Organizations

Foreign embassies, foreign consular offices, and international organizations operating in the US are not required to withhold federal income and social security taxes from their employees' compensation. These entities are also not required to file information reports with the IRS.

This campaigns addresses the unreported income, erroneous deductions and credits, and failure to pay taxes that results from this system. This campaign will concentrate on outreach and education to inform these employees of their legal obligations. The IRS will also issue soft letters and conduct examinations.

Further information about these and other compliance campaigns is available at: https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns-0

By Elizabeth Peterkort, Palo Alto

Leveraged Spinoffs - IRS Private Letter Rulings are Back

On August 17, 2018, the IRS issued private letter ruling ("PLR") 201833011, in which it ruled on certain aspects of a reorganization proposed by a publicly traded corporate group parent ("Distributing") that formed "Controlled" to participate in a securities-for-debt exchange involving an investment bank-held debt of Distributing ("Distributing Exchange Debt"), Controlled senior unsecured notes ("Controlled Securities") and Controlled cash. The PLR contained three rulings: (1) The Controlled Securities will constitute "securities" for purposes of Code section 361(a); (2) No gain or loss will be recognized by Distributing in the Securities-for-Debt Exchange pursuant to section 361(c)(3) other than any (i) deductions attributable to the fact that the Distributing Exchange Debt may be redeemed at a premium, (ii) income attributable to the fact that the Distributing Exchange Debt may be redeemed at a discount, and (iii) interest expense accrued with respect to the Distributing Exchange Debt; and (3) The Controlled Cash will be treated as being distributed by Distributing pursuant to a plan of reorganization for purposes of section 361(b) and section 361(c).

The PLR reflects the IRS's recent change in its ruling policy on section 355 transactions and related issues, including its willingness to issue rulings on the overall federal income tax consequences of divisive reorganizations and other distributions under section 355 as well as various aspects of leveraged spinoff transactions.

By way of background, in a spinoff transaction intended to qualify under section 355, one corporation (Distributing) distributes the stock or securities of a corporation that it controls (Controlled) to its shareholders and/or creditors. Prior to the spin-off, Distributing will typically contribute assets and liabilities to Controlled in exchange for Controlled stock in a transaction intended to qualify as a tax-free reorganization under section 368(a)(1)(D). If properly structured, Controlled can also distribute cash and Controlled securities ("Section 361 Consideration") in the reorganization that Distributing can use to retire existing Distributing debt without gain recognition to Distributing or Controlled ("leveraged spin-off"). Section 361(a), in relevant part, provides that Distributing does not recognize any gain or loss on a transfer of property to Controlled in a reorganization within the meaning of sections 368(a)(1)(D) and 355 if Distributing receives solely stock and securities of Controlled in the exchange. Section 361(b) provides that Distributing will not recognize any gain or loss on the transfer of property to Controlled where Distributing receives other property (in addition to stock and securities) from Controlled in the exchange, and Distributing distributes such other property to Distributing's shareholders. Section 361(b)(3) similarly provides that Distributing will not recognize gain or loss on such a transfer in exchange for stock and securities and other property from Controlled, provided that Distributing distributes the other property to Distributing's creditors. Section 361(b)(3), however, will only apply to the extent that the sum of the money and the fair market value of other property does not exceed the adjusted basis of the assets transferred, reduced by the amount of the liabilities Controlled assumes. Under section 361(c)(3), Distributing recognizes no gain or loss on the distribution of the stock or securities received from Controlled pursuant to a reorganization described in section 368(a)(1)(D) to its shareholders or creditors as part of the same plan of reorganization.

In Rev. Proc. 2013-3, the IRS expanded its areas under study in which rulings would not be issued on whether either section 355 or section 361 applies to Distributing's distribution of stock or securities of Controlled in exchange for, and in retirement of, any putative debt of Distributing if such distributing corporation debt is issued in anticipation of the distribution. In Rev. Proc. 2013-32, the IRS announced that it would no longer issue rulings on the general federal income tax consequences of spinoff transactions intended to qualify as tax-free under section 355 and instead would only issue spin-off rulings on selected “significant issues."

Prior to 2013, the IRS issued favorable PLRs with respect to leveraged spinoffs. As a condition, taxpayers represented that the sum of Distributing debt exchanged for Controlled securities and repaid with cash from Controlled would not exceed the weighted quarterly average of the Distributing debt for the 12-month period ending on the close of business on the last full business day before the date on which Distributing’s board initially discussed the potential spin-off. In addition, where a financial institution acquired Distributing debt, the IRS applied a "5/14 safe harbor", which required that Distributing debt be held (1) for at least five days before Distributing and the financial institution enter into an agreement to exchange the stock (or securities) of Controlled for the debt and (2) for at least 14 days before the exchange is effected.

However, in Rev. Proc. 2017-38, citing the "interest of sound tax administration," the IRS stated that it would rule on whether section 355 or 361 applies to a corporation’s distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation, if that debt is issued in anticipation of the distribution. In Rev. Proc. 2017-52, the IRS introduced an 18-month “pilot program”, during which it would issue rulings on the general federal income tax consequences of spinoff transactions intended to qualify as tax-free under section 355, and collateral issues commonly arising in spinoff transactions. Furthermore, on October 3, 2018, the IRS announced that while it is continuing to study the issues relating to assumption and satisfaction of Distributing Debt in divisive reorganizations, it has determined that taxpayers requesting rulings on certain of these issues should follow specified procedures and submit specified representations and related information and analysis (Rev. Proc. 2018-53).

Rev. Proc. 2018-53 contains procedural guidance that taxpayers must follow to the extent the request involves an assumption by Controlled of Distributing debt or satisfaction of Distributing debt with Section 361 Consideration if: (1) Distributing is the obligor of such debt, and (2) the obligation is (a) evidenced by a debt instrument that is not a contingent debt instrument, and (b) by its terms is payable only in money. The revenue procedure outlines representations, information, and analysis that taxpayers should include in their PLR requests. In addition to submitting the usual detailed description of facts and law common to all PLR requests, taxpayers must submit the following fixed set of representations:

1. Distributing is in substance the obligor of each Distributing debt that will be assumed or satisfied.

2. No holder of Distributing debt that will be assumed or satisfied is a person related to Distributing or Controlled (Related Person).

3. The holder of Distributing debt that will be assumed or satisfied will not hold the debt for the benefit of Distributing, Controlled, or any Related Person. A collateral benefit received by Distributing from an arrangement with an intermediary (for example, facilitation of exchanges of Section 361 Consideration for Distributing debt) will not be treated as the intermediary

holding Distributing debt for the benefit of Distributing, Controlled, or a Related Person (subject to additional representations that must be submitted).

4. Distributing incurred the debt that will be assumed or satisfied (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement of the Divisive Reorganization or a similar transaction, (ii) the date of the entry by Distributing into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by the board of directors of Distributing.

5. The total adjusted issue price of Distributing debt that will be assumed or satisfied does not exceed the historic average of the total adjusted issue price of (a) Distributing debt owed to persons other than Related Persons and (b) obligations that are evidenced by Non-contingent Debt Instruments and are owed by other members of Distributing's separate affiliated group to persons other than Related Persons.

6. There are one or more substantial business reasons for any delay in satisfying Distributing debt with Section 361 Consideration beyond 30 days after the date of the first distribution of Controlled stock and such debt will be satisfied with Section 361 Consideration no later than 180 days after such distribution.

7. Distributing will not replace any Distributing debt that will be assumed or satisfied with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement.

The IRS intentionally kept representations general in order to allow the taxpayers to explain other factors relevant to the transactions. Noticeably absent from the above list of representations is the "5/14 rule." According to Robert Wellen, IRS Associate Chief Counsel (Corporate), a significant purpose of the guidance was to "turn off the 5/14 idea", as part of the IRS's attempt to avoid inserting itself into the mechanics of the transaction. Wellen also emphasized three themes underlying the revenue procedure: (1) the guidance is narrowly focused on fixed leverage transactions (i.e. transactions not involving the assumption or indemnity of contingent liabilities); (2) the IRS is less concerned about the precise mechanics of the transaction, and more concerned with the purpose of the transaction (i.e., allocating Distributing's historical leverage to Controlled under section 361); and (3) with respect to Distributing's historical leverage, the focus is on identifying the amount of debt within the group, and there is less of a concern as to the exact timing of when such debt was incurred (*see* Guidance on Leveraged Spinoff Rulings Designed for Flexibility, Emily Foster, Tax Notes (Oct. 10, 2018)).

By Tatyana Johnson and Jayshree Narendran (New York)

Treasury and IRS Release Proposed GILTI Guidance

On September 13, 2018, Treasury and the IRS released proposed regulations under section 951A. The proposed regulations provide some important guidance with regard to various mechanical and computational aspects of the Global Intangible Low-Taxed Income ("GILTI") regime, as well as rules on reporting requirements. The proposed regulations also include revisions to Treas. Reg. § 1.951-1 to address certain "avoidance structures" under the pro rata share rules, to coordinate certain aspects of the subpart F and GILTI regimes, and also to reflect statutory changes to the definition of US shareholder and the elimination of the so-called 30-day requirement. The proposed regulations do not contain any rules on the foreign tax credit (including rules on expense allocation to the section 904(d)(1)(A) GILTI basket) as it relates to GILTI. The preamble states that such rules will be included in separate notices of proposed rulemaking. The preamble does provide that "it is anticipated" that the section 78 gross-up related to the section 951A inclusion will be assigned to the GILTI basket.

The proposed regulations provide detailed rules on many of the computational aspects of the GILTI regime including:

- the calculation of tested income and tested loss;
- the calculation of the amount of qualified business asset investment (or "QBAI");
- rules on tested interest expense and tested interest income;
- the effect of the GILTI inclusion amount on earnings and profits and the basis in the stock of the relevant foreign corporations;
- basis adjustments as a result of using a tested loss; and
- rules for determining the GILTI inclusion amount for domestic partnerships and their partners.

The proposed regulations include anti-abuse rules to disregard basis in certain circumstances if the basis either (i) could affect the amount of QBAI or (ii) would result in a deduction or loss (e.g., amortization deductions with respect to intangibles) that, absent the application of the anti-abuse rule, would be allocated and apportioned to gross tested income of the CFC.

Citing to section 7805(b)(2), the preamble states that the proposed regulations under section 951A and 1502 will apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of US shareholders in which the taxable years of such foreign corporations end. The proposed regulations under Treas. Reg. § 1.951-1 addressing the pro rata share rules will apply to taxable years of US shareholders ending on or after the date the proposed regulations are filed with the Federal Register.

For a more detailed discussion of these proposed regulations, please see the Baker McKenzie Client Alert, "*Treasury and IRS Release Proposed GILTI*

Guidance," distributed on October 3, 2018 and also available under Insights at www.bakermckenzie.com. Among other observations, the Client Alert noted that the validity of the anti-abuse rule in the proposed regulations that targets basis step-up transactions with respect to intangibles that occur between January 1, 2018 and the date on which the acquiring CFC becomes subject to GILTI is highly questionable. We expect taxpayers will challenge this rule on validity grounds. Please refer to the client alert for additional observations with respect to other aspects of the proposed regulations. Any written or electronic comments on the proposed regulations and requests for a public hearing must be received by Treasury within 45 days of publication of the proposed regulations in the Federal Register (which occurred on October 10, 2018).

By Moe Worsley and Adam O'Brien, San Francisco

Notice 2018-71 Provides Guidance on New Employer Credit for Paid Family and Medical Leave

On September 24, 2018, the IRS issued Notice 2018-71 ("Notice") on the temporary employer tax credit introduced by the Tax Cuts and Jobs Act for wages paid to Qualifying Employees while on covered family or medical leave under new Code Section 45S. The Notice expands on initial IRS FAQs and a subsequent IRS Tax Reform Tax Tip 2018-69 by providing 34 Q&As which clarify how to calculate and claim the credit and address the steps employers must take to do so. (Follow the links to view full documents).

In Brief:

Where the requirements of the Notice are met, the new credit may be claimed during tax years 2018 and 2019 for paid family and medical leave provided to employees whose prior year compensation was at or below a certain amount ($72,000 for 2018). Eligible employers who establish qualifying paid leave programs or amend existing programs by December 31, 2018, may claim the credit, retroactive to the beginning of the employer' s 2018 tax year for paid leave provided during the year pursuant to the program.

Notice 2018-71's Guidance:

The credit under section 45S is equal to 12.5% of wages paid to a Qualifying Employee while on leave for up to 12 weeks in a tax year for a purpose that is protected by the Family and Medical Leave Act of 1993 ("FMLA") and receiving 50% of normal wages. The amount of the credit is increased by 0.25% for each percentage point by which the rate of paid leave exceeds 50% of normal wages, up to a maximum credit of 25% where a Qualifying Employee receives 100% of his or her normal pay while on leave.

As explained by the Notice, to claim the credit, an employer must have a written policy that:

(1) Covers all employees who have been employed for one year or more and were paid not more than 60% of the threshold for highly

compensated employees under section 414(q) in the preceding year (*i.e.*, $72,000 for 2018) ("Qualifying Employees");

(2) Provides at least two weeks of annual paid family and medical leave for each full-time Qualifying Employee and a proportionate amount of leave for each part-time employee;

(3) Provides payment of at least 50% of a Qualifying Employee's normal wages while on leave ("normal wages" generally excludes overtime and discretionary bonuses); and

(4) Includes specified "non-interference" language if the employer has Qualifying Employees who are *not* covered by title I of FMLA (*e.g.*, employees working fewer than 1,250 hours per year), whereby the employer commits not to interfere in any way with a Qualifying Employee's exercise of paid leave rights under the policy. (Sample language is provided.)

Where an employer provides paid leave for both FMLA purposes and other purposes (*e.g.*, vacation or personal leave), the written policy must specifically designate the leave provided for FMLA purposes in order to qualify for the credit for such leave. For example, a paid maternity or paternity leave policy that provides additional paid leave (over and above vacation, sick leave or other paid time off) would likely qualify.

Any leave paid by a State or local government or required by State or local law is not counted when determining whether an employer's written policy provides a rate of payment of at least 50% of a Qualifying Employee's normal wages. Therefore, in states such as California, New Jersey, New York and Rhode Island which provide State-funded paid family and/or medical leave that may be used for FMLA purposes, employers will need to provide 50% of normal wages on top of any State-funded amount to qualify for the credit.

In contrast, it appears that amounts paid by a third-party payer, such as an insurance company or a professional employer organization, will count as wages for purposes of the credit, but only the employer may take such wages into account in determining the credit.

An employer is not required to provide employees with notice of its paid family and medical leave policy, but if it chooses to do so, it must provide notice in a way reasonably designated to reach each Qualifying Employee.

The Notice ensures no "double-dipping" with respect to the credit as it confirms that any wages taken into account to determine any other business-related credit under section 38 do not count as wages for purposes of the new section 45S credit. Additionally, section 280C denies a deduction for wages or salaries equal to the amount of the new credit.

Next Steps:

The IRS plans to incorporate the content of the Notice into proposed regulations and has requested comments by November 23, 2018 to assist in development of the regulations. In the meantime:

- Employers that already provide paid leave for an FMLA purpose should consider adopting or amending their written policy to meet the requirements of the Notice by December 31, 2018, which will enable them to claim the credit for any qualifying leave provided since January 1, 2018 (as well as in 2019).

- Employers that do not currently provide paid FMLA leave should consider whether the temporary credit under section 45S provides sufficient tax incentive for them to adopt a FMLA leave policy.

By Anne Batter, Washington, DC and Sinead Kelly, San Francisco

New Jersey Amends Key Corporation Business Tax Provisions

On October 4, 2018, New Jersey Governor Phil Murphy signed legislation ("A. 4495") amending certain provisions of the New Jersey Corporation Business Tax ("CBT") reform bill that was enacted in July of this year (the "Budget Bill"), which implements sweeping changes to the CBT. Notable changes include, among others, the adoption of mandatory unitary combined reporting, market-based sourcing, and a new four-year surtax on corporations with over $1 million of allocated taxable net income. The Budget Bill and A. 4495 also respond to changes made to the Internal Revenue Code ("IRC") in connection with the enactment of the Tax Cuts and Jobs Act ("TCJA") in December 2017.

The Budget Bill's adoption of mandatory unitary combined reporting represents a significant departure from New Jersey's current law, which requires taxpayers to compute their CBT on a separate-entity basis. Business entities will be required to file on a combined basis if they are engaged in a unitary business and a more-than-50-percent common ownership test is met. As a result of A. 4495, the combined reporting provisions, which were initially effective for tax years beginning on or after January 1, 2019, are now effective for tax years ending on or after July 31, 2019. In addition, the Budget Bill adopts a market-based approach to source receipts from the sale of services. Under this approach, receipts from the sale of services are sourced to New Jersey "if the benefit of the service is received at a location in [New Jersey]." We expect that New Jersey (like many other market-based sourcing states) will craft regulations to further expand on its market-based sourcing standard and taxpayers should be prepared to carefully review and comment on any draft regulations that are proffered.

The Budget Bill (as amended by A. 4495) imposes a new four-year surtax on corporate taxpayers with allocated taxable net income in excess of $1 million. The surtax is imposed at a 2.5% rate for tax years beginning on or after January 1, 2018, through December 31, 2019, and at a 1.5% rate for tax years beginning on or after January 1, 2020 through December 31, 2021. For taxpayers impacted by the surtax, the New Jersey corporate income tax rate clocks in at 11.5% in the initial two-year period (up from 9%).

In response to the Tax Cuts and Jobs Act (i.e., federal tax reform), the Budget Bill decouples from the 20% deduction available to pass-through entities set forth in section 199A of the IRC and conforms to the interest deduction limitation of section 163(j), which will be applied on a pro rata basis to interest paid to both

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related and unrelated parties, regardless of whether the related parties are subject to New Jersey's related-member addback provision. A. 4495 conforms to the deduction allowed under section 250 of the IRC related to foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI), provided the corresponding income to which the deduction relates has not been excluded or exempted pursuant to any other CBT provision.

The Budget Bill and A. 4495 significantly overhaul the CBT and may result in substantial changes for many taxpayers. For a more in-depth summary of these changes, please see *New Jersey Legislature Approves Amendments to Key Corporation Business Tax Provisions* on the SALT Savvy blog, available at www.saltsavvy.com.

By Michael C. Tedesco, New York

How Tax Disputes Threaten to Wipe out More Than Half of Fortune 500 Profit Growth

On September 10, 2018, Baker McKenzie released its tax leadership campaign, "The Shape of Water." This is the first piece of commissioned thought leadership for the global tax practice and the findings have been featured in business press around the world. In a nutshell, nearly all our clients are affected, the number of tax disputes are rising, and clients feel ill equipped to meet this new challenge.

The report explores the steep rise in tax disputes, the impact on multinational organizations and the steps companies can be taking to cope with the raft of disputes. Our independent research found that amongst the Fortune 500, the amount of tax under dispute is so large (as much at $75bn) that it threatens to wipe out more than half of profit growth in the Fortune 500. Locating and isolating value - particularly in the digital age - is the key source of contention between organizations and authorities. For a more detailed discussion, please see "*The Shape of Water*" publication available at www.bakermckenzie.com/insight.

Getting Better All The Time…Baker McKenzie Adds New Talent to its Controversy, Planning, and Policy Groups

Baker McKenzie is pleased to announce the arrival of two Tax Partners to its Tax Practice Group. These additions enhance our capabilities in North America and further our ability to provide unmatched service to our clients.

With over 20 years of experience, **Eliud Santiago** comes to the Firm as a partner in our Mexico City office. He most recently served as the International Tax Surveillance Director for the Servicio de Administración Tributaria. His experience there broadens our tax policy presence in Mexico and complements our US and global tax policy practices. Eliud's practice will focus on advising clients on various tax planning issues such as, domestic and international tax and transfer pricing matters, compliance issues, audits and conclusive proceedings before tax authorities, and corporate and operative restructurings. He is uniquely positioned to provide guidance to our clients in Mexico on the evolving tax environment created by US tax reform and changes in Mexico tax laws.

Amit Ummat joins Baker McKenzie as a tax partner in our Toronto office. With more than 10 years of experience, Amit has actively litigated cases in the Canadian Tax Court, Federal Court, Federal Court of Appeal, and the Supreme Court. Previously serving as Tax Counsel at the Canadian Department of Justice, Amit argued over 80 tax appeals. His practice will focus on advising clients with regard to tax disputes at the administrative level. Additionally, Amit has extensive experience managing all aspects of discovery and tax controversy management.

Amit received his LLM and LLB from Osgoode Hall Law School and is a regular contributor to *Tax Disputes Case Law Weekly Update,* a Thomson Reuters publication.

Please join us in welcoming Eliud and Amit to Baker McKenzie!

Tax News and Developments is a periodic publication of Baker McKenzie's North America Tax Practice Group. The articles and comments contained herein do not constitute legal advice or formal opinion, and should not be regarded as a substitute for detailed advice in individual cases. Past performance is not an indication of future results.

Tax News and Developments is edited by Senior Editors, James H. Barrett (Miami) and David G. Glickman (Dallas), and an editorial committee consisting of Glenn G. Fox (New York), Gwen Hulsey (Houston), Joseph A. Myszka (Palo Alto), John Paek (Palo Alto), Alex Pankratz (Toronto), Julia Skubis Weber (Chicago), and Robert S. Walton (Chicago).

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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