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The New Anti-Inversion Regulations (Incl. Proposed Debt/Equity Rules)

J. Brian Davis

Penn State Law – Center for the Study of Mergers & Acquisitions
New Treasury / IRS Tax Inversion and § 385 Interest-Stripping Regulations
27 April 2016

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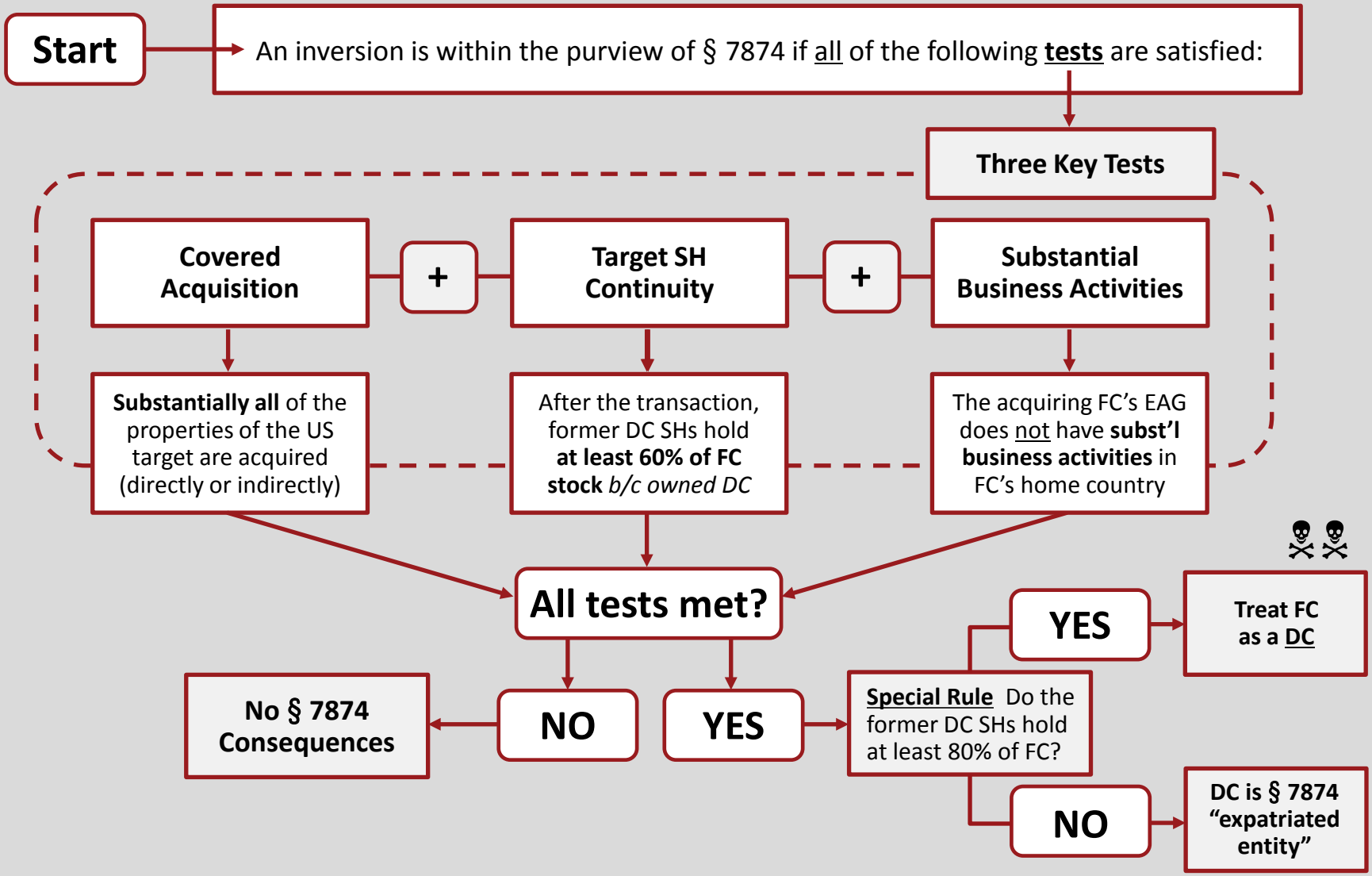
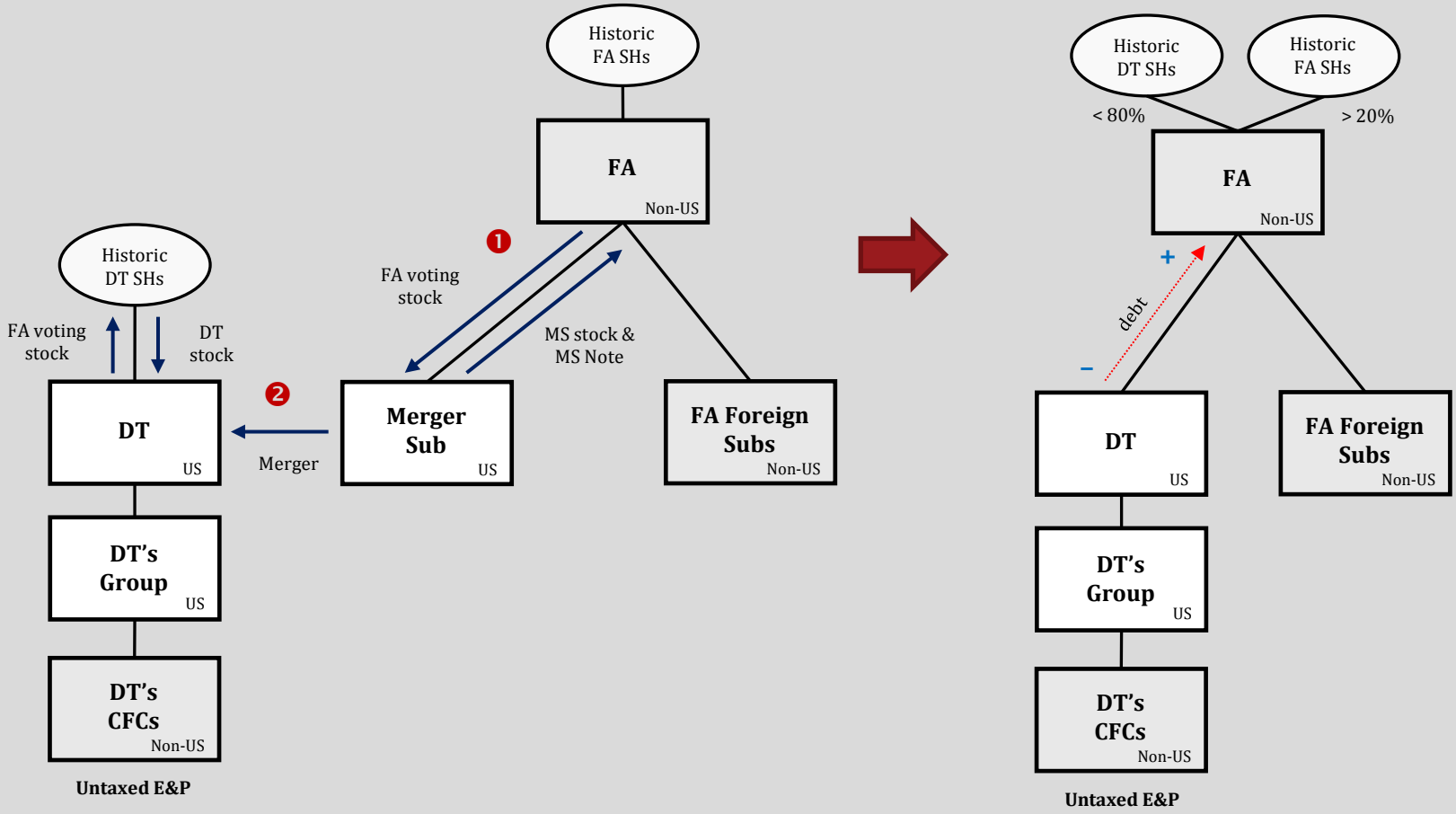
Inversion Background

§ 7874 Statutory Framework



A Typical Inversion



Temporary Inversion Regs

Background

Temporary inversion regulations (TD 9761) issued Apr. 4, 2016

Backdrop for temporary regs

- Inversion activity
- Hill support
- Earlier guidance – Notices 2014-52 and 2015-79

Notice No. 1 – Sept. 22, 2014

- ***Rules making it harder to invert***
  - Ownership test – anti-cash box; FA excessive passive-asset rules (§ 7874) – § 2.01
  - Ownership test – anti-slimming (NOCD) rule; DT-slimming distributions (§ 367 / § 7874) – § 2.02
  - Ownership test – "spinversions"; EAG rules and subsequent transfers of stock of FA (§ 7874) – § 2.03
    - US-parented group rule
    - Foreign-parented group rule [a taxpayer-friendly rule]
- ***Rules to address post-inversion planning***
  - § 956 anti-hopscotch; acquiring stock/obligations that would otherwise avoid § 956 – § 3.01
  - De-controlling / diluting CFCs – stock dilution (§ 367(b) / § 7701(l)) – § 3.02
  - Rules under § 304 to prevent E&P removal – § 3.03

Background (cont.)

Notice No. 2 – Nov. 19, 2015

- ***Rules making it harder to invert***
  - SBA test – tax residency requirements (§ 7874) – § 2.02(a)
  - Ownership test – third-country rule ; FT / new FA aligned tax residency requirement (§ 7874) – § 2.02(b)
  - Ownership test – anti-stuffing rule (FA) / clarification of "avoidance" property (§ 7874) – § 2.03
- ***Rules to address post-inversion planning***
  - "Inversion gain" – to include indirect transfers / transactions w/r/t specified foreign persons (§ 7874) – § 3.01
  - Dilution / de-control transactions – § 1248 pickup *and* all stock gain triggered (§ 367(b) / § 7701(l)) – § 3.02
- ***Corrections / clarifications to Notice No. 1***
  - Ownership test – anti-cash box – revised definition of "foreign group non-qualified property" (insurance cos.) – § 4.01
  - Ownership test – anti-slimming (NOCD) rule – inclusion of a *de minimis* exception – § 4.02
  - Dilution / de-control rule – clarifying the small dilution exception computation – § 4.03

Earning-stripping guidance – suggested in prior guidance (now see later slides)

Applicability dates – generally follows prior guidance, other than in respect of new rules

Making it Harder to Invert

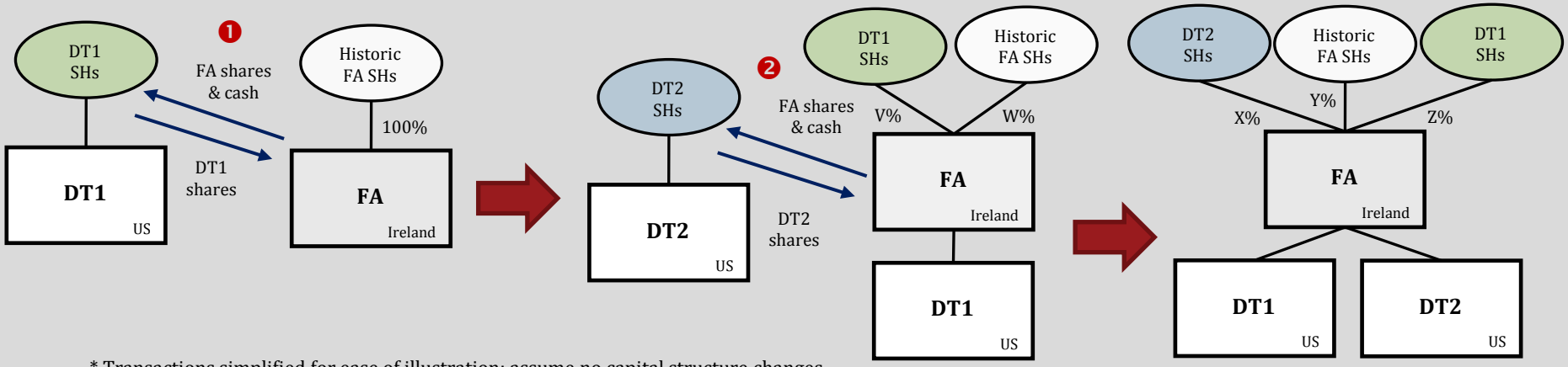
Guidance implementing Notices Nos. 1 & 2

Rule	Location
Anti-cash box rule (incl. revised definition)	Reg. § 1.7874-7T
"Avoidance property" clarification	See Reg. § 1.7874-4T
NOCD rule (incl. *de minimis* exception)	Reg. § 1.7874-10T (see also Reg. § 1.367(a)-3T)
Third-country rule	Reg. § 1.7874-9T
EAG / spinversions (subsequent FA stock transfers)	Reg. § 1.7874-6T
Tax residency rule (SBA)	Reg. § 1.7874-3T

New rules – April 2016

- "Serial inverter" rule
- Multiple-step DT acquisition rule
- NOCD directionality rule

"Serial Inverter" Rule

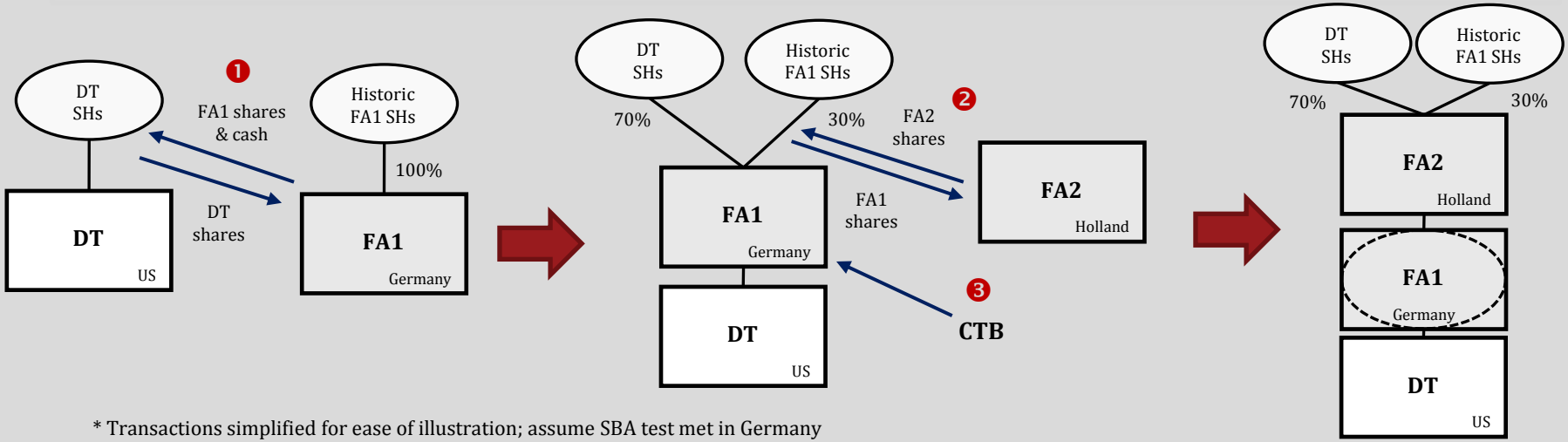


* Transactions simplified for ease of illustration; assume no capital structure changes

Reg. § 1.7874-8T – Acquiring multiple DTs

- *Background* – the mathematical nature of the ownership test gives rise to a concern that § 7874 might simply be avoided by "bulking up" via acquisitions – i.e., each new deal operates to diminish likelihood of triggering § 7874. *Observe* (example above) that the presence of V% makes it more likely that X% will fail to cross a § 7874 threshold
- *Preamble* – T/IRS concerned that a single FA could avoid § 7874 by acquiring multiple DTs "over a relatively short period of time" even though § 7874 might otherwise have been triggered if the acquisitions had been made at the same time or pursuant to a plan
- *Authority for new rule* - § 7874(c)(6), § 7874(g)
- *New rule* – the -8T regs provide the *value* of FA stock issued to former DT shareholders (in earlier acquisitions) during the 3-year period preceding the *signing date* (first date of binding agreement) of the present DT acquisition will be *excluded* from *denominator* of ownership fraction for purpose of testing ownership for *this* DT acquisition
- *Bright-line* – the rule is irrefutable and does not turn on facts, the presence of a plan or otherwise – only requires that DT acquisitions have occurred. *De minimis* exception is available – i.e., don't count as a *DT acquisition* a situation where (1) ownership w/r/t such DT acquisition < 5%, and (2) the FMV of by-reason-of stock did not exceed $50M
- *Contrast* – historic *conspiracy rule* at Reg. § 1.7874-2(e)

Multi-Step DT Acquisition Rule

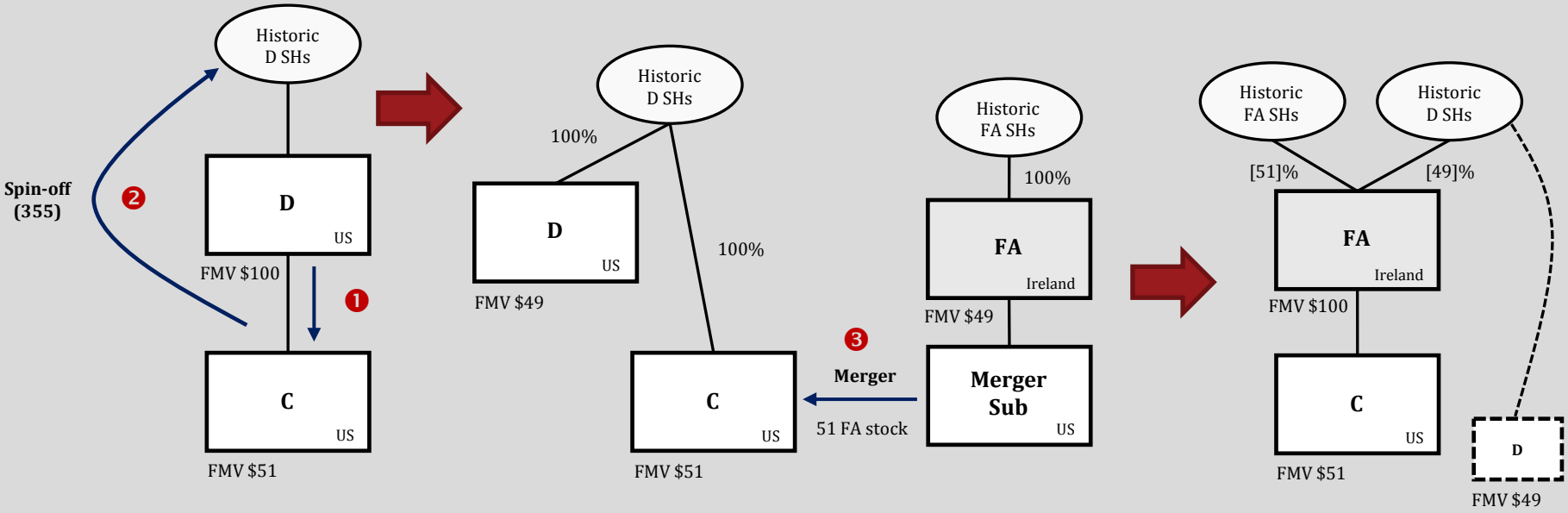


* Transactions simplified for ease of illustration; assume SBA test met in Germany

Reg. § 1.7874-2T(c)(4) – Multi-step acquisitions

- *Background* – under current regs, there are many multi-step rules. For instance, FA's acquisition of multiple DTs pursuant to a plan are aggregated under the *conspiracy rule* (Reg. § 1.7874-2(e)); similarly, multiple FAs are each treated as acquiring sub all of DT assets if such FAs complete a "sub all" acquisition pursuant to a plan (see Reg. § 1.7874-2(d)). Lastly, and most importantly, Reg. § 1.7874-2(c)(2) exempts *FA's acquisition of another FC that owns DT* on the premise that DT already foreign-parented (thus not viewed as "indirect" DT acquisition)
- *Preamble* – T/IRS concerned that the *indirect acquisition exception* can be used to circumvent other rules (such …
- *Preamble* (cont.) – … as the third-country rule, subject to tax, SBA tests); thus, the temporary regs extend the rules to address *multiple related acquisitions of single DT* pursuant to a plan
- *New rule* – new Reg. § 1.7874-2T(c)(4) treats a *subsequent acquisition* (e.g., an acquisition of FA1 by FA2, following FA1's acquisition of DT) as a *DT acquisition* such that (1) FA2 is treated as the FA, and (2) FA2 stock is treated as by-reason-of stock to the extent it is received for FA1 by-reason-of stock. The rule applies where there is a plan involving multiple acquisitions
- *No impact on initial DT acquisition* – While new rule does not impact application of § 7874 to first acquisition, it will mean subsequent acquisition is subject to §7874 testing

NOCD Directionality Rule



* Simplified facts; assume no other extraordinary distributions by any party (clean)

Reg. § 1.7874-10T(g) – NOCD directional rule

- *Relevant authorities* – § 7874(c)(4), § 7874(g)
- *Background* – Notice 2014-52 first introduced NOCD rule, which targets attempts to "skinny-down" DT prior to its acquisition (i.e., lower DT value means ownership fraction less likely to cross § 7874 thresholds). NOCD rule is *per se* rule that adds back value of "extraordinary distributions" made by DT during prior 36-month period (from closing). For spins, D (but not C) was covered
- *New rule* – if immediately before the spin, Controlled's (C) FMV represents *more than 50%* of FMV of Distributing (D) stock, then C is deemed (on the spin date) to have distributed the FMV of D stock (backing out the FMV of C stock built-in to D stock value) as of the spin date.
- *Impact* – the new rule eliminates the directionality of the earlier NOCD proposal. If triggered, the new rule will create a C *distribution* that must be taken into account in running the NOCD analysis. In above, DT shareholders' ownership fraction should be $100 over $149, or 67.1%

Post-Inversion Planning

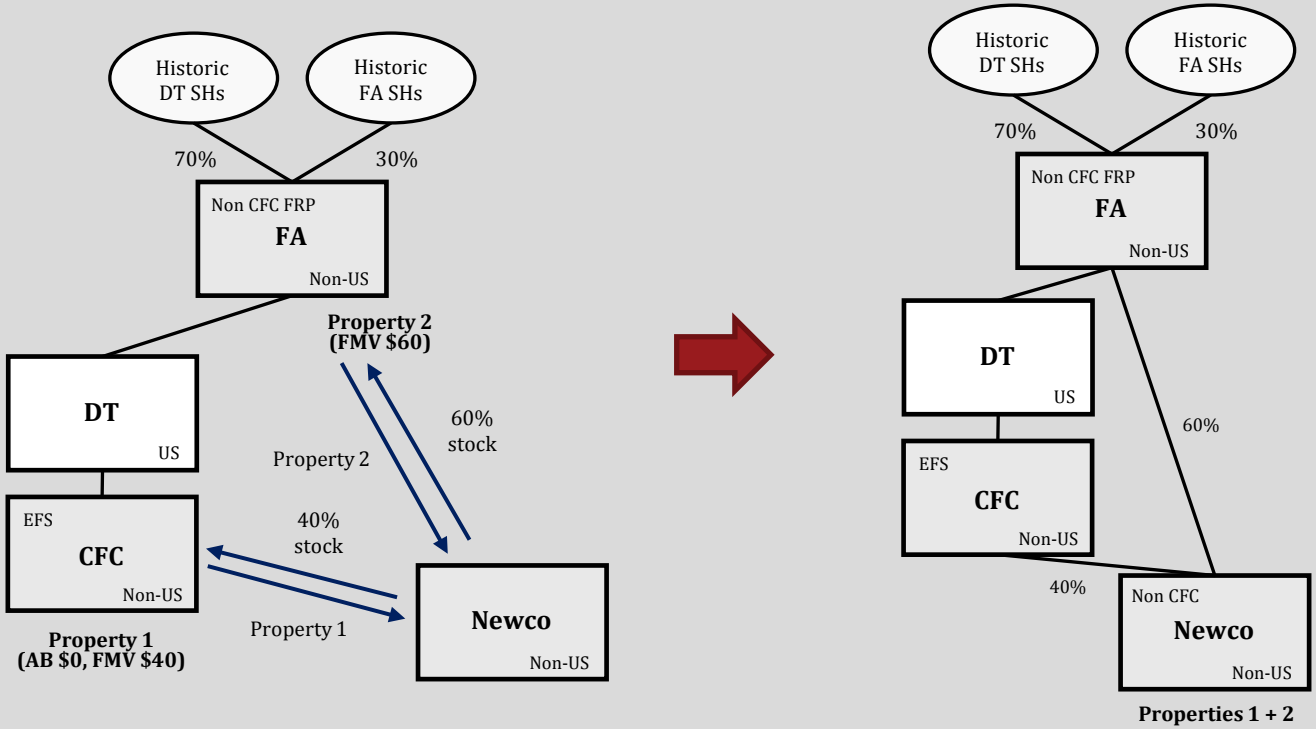
Guidance implementing Notices Nos. 1 & 2

Rule	Location
§ 956 anti-hopscotch rule	Reg. § 1.956-2T
De-controlling / diluting CFCs (stock dilution) (§ 7701(l) / § 367(b))	Reg. § 1.7701(l)-4T Reg. § 1.367(b)-4T(e)
§ 304 rules to prevent removal of E&P	Reg. § 1.304-7T
Inversion gain	Reg. § 1.7874-11T

New rules – April 2016

- § 367(b) asset dilution rule

§ 367(b) Asset Dilution Rule



Reg. § 1.367(b)-4T(f) – Asset dilution rule

- *Background* – T/IRS are concerned that valuable assets with BIG over which US has taxing authority (e.g., IP) might be removed from the US system via a § 351 *asset* dilution transaction such as that depicted above (where the asset then resides in a non-CFC); the deferral of recognition essentially allows E&P associated with the gain to escape the US tax system
- *New rule* – if an "expatriated foreign sub" (EFS) transfers any property (other than stock in a lower tier EFS) to a FC in a § 351 during the "applicable period", then the EFS must *recognize* all BIG not otherwise required to be recognized, *unless* an *exception* applies
- *Exception* – an exception to recognition is available only if (1) immediately after, Newco is a CFC, and (2) there is only a *de minimis* dilution effectuated w/r/t the asset

Proposed Intercompany Debt Regs

The Statute & Its History

Section 385 background

- The code provision was enacted in 1969

§ 385

> ***(a)*** ***Authority to prescribe regulations.*** *The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).*
>
> ***(b)*** ***Factors.*** *The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors…[list of suggested factors]*
>
> ***(c)*** ***Effect of classification by issuer.*** *[Generally provides that the issuer's characterization of the instrument at the time of issuance is binding unless notification of inconsistent treatment is reported. The Secretary may require such information as necessary to carry out the provisions of this subsection.]*

- T/IRS issued debt/equity regs in the very early 1980s, but they were withdrawn by late 1983
- Case law developed applicable debt/equity rules

2016 Prop. Regs. – Overview

Proposed § 385 regs (REG-108060-15) issued Apr. 4, 2016

Backdrop for proposed regs

- Inversion activity – see Notices 2014-52 and 2015-79
- BEPS
- Increasingly hostile attitudes toward corporate tax planning (e.g., NGOs, reporters, etc.)

Broad applicability

- Generally applies to debt issued in highly-related (80%) groups involving separate taxpayers
  - "Inverters"
  - Foreign-based MNEs (inbound)
  - US-based MNEs (outbound)
  - Non-consolidated US groups (exceptions for debt issued within consolidated group)
  - REITs / investment fund structures?
- Special 50% relationship test for *bifurcation*(part debt/equity) characterization rule

2016 Prop. Regs. – Overview (cont.)

Substantiation requirement

- Applicable to related-party debt, with some exceptions
- When applicable, is threshold requirement for *debt* characterization
- Must evidence four key characteristics

Interco debt distributions (and similar)

- Debt involved in certain intero-debt transactions will be treated as *equity*
- Targeting *Kraft Foods* (2nd Cir. 1956)
- Particular concerns – situations where debt created with lack of new invested capital
  - Corporate note *distributions*
  - Corporate note issued for *affiliate stock*
  - Corporate note issued in exchange pursuant to *internal asset reorganization*
  - Separate transactions where corporate note issued with a *principal purpose of funding* certain distributions, affiliate stock acquisitions, or property acquisitions
- Complex

Key Concepts

Important GROUP terms / rules

GENERAL APPLICATION

for BIFURCATION rules

EXPANDED GROUP (EG)

A § **1504(a) affiliated group** but with certain modifications:

- Disregard the notion of "includible corporation" (e.g., foreign corporations can be included)
- Count *both* direct and indirect ownership
- Uses an at least 80% vote or value (i.e., not a vote *and* value test)

PR § 1.385-1(b)(3)(i)

MODIFIED EXPANDED GROUP (MEG)

An **EG** but substituting 50% for 80%. Also include within the MEG:

- A partnership that is 50% or more owned (directly or indirectly) by members of the MEG
- A person that is treated (per § 318) as owning at least 50% of the stock of a member of the MEG

PR § 1.385-1(b)(5)

Known as a modified controlled partnership

PR § 1.385-1(b)(4)

compare

Indirect Ownership

Use § 304(c)(3) principles – i.e., generally use § 318(a) constructive ownership rules (but when attributing to/from corporations, use 5% threshold rather than 50%)

PR § 1.385-1(b)(3)(ii)

Controlled Partnership

Partnership w/r/t at least 80% of its interests are owned (directly/indirectly) by 1+ members of EG

PR § 1.385-1(b)(1)

Consolidated Group Rule:

If entities file as ***consolidated group***, then treat all members of consolidated group (as determined under consolidated regs) as one corporation. See PR § 1.385-1(e)

Key Concepts (cont.)

Important DEBT terms / rules

APPLICABLE INSTRUMENT (AI)

Any interest issued (or deemed issued) *in the form of a debt* instrument (note: if not in the form of a debt instrument, the regulations are "[RESERVED] ")

PR § 1.385-2(a)(4)(i)(A)

EXPANDED GROUP INSTRUMENT (EGI)

An **applicable instrument** w/r/t which

(1) an **issuer** of which is one member of an EG; and

(2) the holder of which is another member of the same EG

PR § 1.385-2(a)(4)(ii)

ISSUER

A person (including a DRE) that is *obligated to satisfy* any *material obligations* created under the terms of an EGI – even if that person is not the primary obligor thereof.

Note: A *guarantor* is not a issuer (unless expected to be the primary obligor)

PR § 1.385-2(a)(4)(iii)

Consolidated Group Rule:

If entities file as ***consolidated group***, then treat all members of consolidated group (as determined under consolidated regs) as one corporation. See PR § 1.385-1(e)

EGIs – Threshold Test

THRESHOLD TEST (for EGIs)

- **Substantiation rule:**

  An EGI will be treated as *stock* (not debt) unless the substantiation requirements are continuously satisfied.

  PR § 1.385-2(b)(1)(i)

  - Satisfying the substantiation requirements does not confirm *debt* characterization, but failing to satisfy the requirements means that "the EGI will be treated as *stock*." PR § 1.385-2(a)(1)

- **Contemporaneous documentation reqmt** – the documentation required must support:
  - *Unconditional Obligation to Pay Sum Certain* – timely, written documentation
  - *Existence of Creditor's Rights* – written documentation must support existence of creditor's rights (e.g., right to trigger default, payment acceleration), including superior right to assets in liquidation
  - *Reasonable Expectation of Ability to Repay EGI* – written analysis (contemporaneous with issuance) that establishes that issuer's financial position supports a reasonable expectation it could meet obligations
  - *Evidence of Ongoing Debtor-Creditor Relationship* – written evidence that EGI terms continuously met (e.g., wire transfer records) or that holder acted as creditor in situations suggesting events of default

- **Maintenance / tender to IRS upon request**

- **Small taxpayer exception**

Potential Bifurcation – Part Debt / Stock

BIFURCATION treatment

- **Special rule:**

The IRS may treat an EGI (AI?)* as *part debt / part stock* if:

(1) issuer and holder are members of same **MEG**, and

(2) IRS analysis (relevant as of date of instrument's issuance) results in a determination that it is only in part debt for federal tax purposes

PR § 1.385-1(d)

- ***Example*** – IRS analysis supports a reasonable expectation that, as of issuance, only a portion of principal will be repaid
- ***Substantiation requirements*** – if applicable, still needed for any remaining portion to be debt
- Issuer's initial characterization of instrument as debt will bind all others (but not IRS); holder may not utilize § 385(c)(2) to disclose on its return an inconsistent position (including part debt / stock)
- ***Practical observation*** – because MEG captures broader group than EG, rule effectively means that EGI held within EG could potentially be characterized as part debt/equity
- ***Drafting note*** – drafting suggests that (1) an AI issued between members of MEG is not captured, but (2) an EGI issued/held by members of same MEG (e.g., EGI that is transferred, in whole/part, to a member belonging to the MEG but not EG) is captured. Is this the intended interpretation?

Recharacterization Rules

Overview – Prop. Reg. § 1.385-3

- ***Basic approach*** – the regulations provide two principal rules that operate to recharacterize (in whole or in part) a debt instrument (even if substantiation requirements satisfied) as ***stock***
- ***Conceptual underpinnings*** – the rules basically look at intercompany debt transactions where a debt is (in form) issued without a new capital investment
- ***Recharacterization*** – if the rules apply, the instrument is recast (in whole/part) as stock and will be treated as stock for all US federal income tax purposes. PR § 1.385-3(b)(1)
  - Although *eliminating interest deduction* is a key objective, recharacterization impact is larger
  - Can impact withholding tax (e.g., dividends vs interest), modify subchapter C application, trigger changes in structure (e.g., consolidation), impact FTC availability, etc.
  - Terms of debt instrument influence the *type* of stock resulting from recharacterization

Principal operative rules

- ***General rule*** – targets three (3) specific paradigm transactions
- ***Funding rule*** – operates as a backstop to the general rule, capturing *multi-step* situations

The General Rule

General rule:

Except as otherwise provided, a **debt instrument** is treated as ***stock*** to the extent it is **issued by a corporation to** a member of the **same EG** in any of the following scenarios:

(1) in a *distribution*

(2) in exchange for *EG stock* (other than in an "exempt exchange")

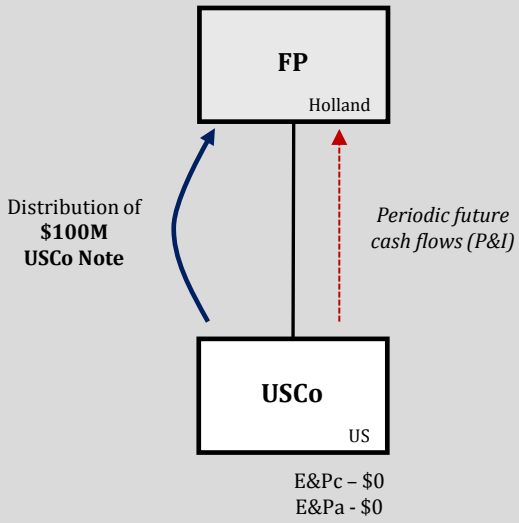
(3) in exchange for property in an *asset reorganization* (but only to extent that a SH that is a member of issuer's EG immediately before the reorganization receives the debt instrument with respect to its stock in transferor)

PR § 1.385-3(b)(2)

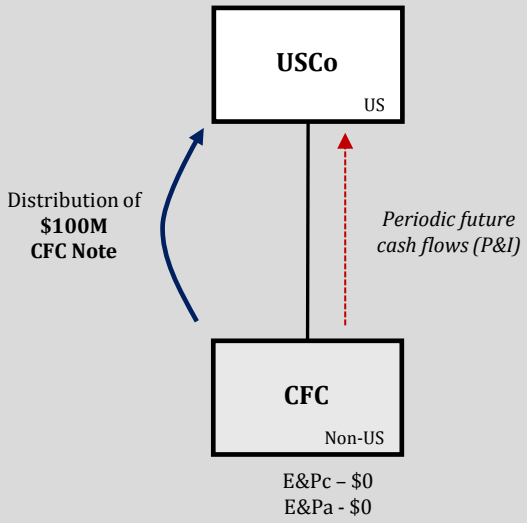
- Distribution – broadly defined as *any* distribution by a corporation with respect to its stock
- Two key exceptions:
  - Current year E&P exception – aggregate distributions captured above are *reduced* by the amount of the distributing member's *current-year* E&P. See PR § 1.385-3(c)(1)
  - "Threshold" exception – a debt instrument is not recharacterized if, immediately after issuance, the aggregate AIP of debt instruments held by members of the EG (that would otherwise be recharacterized under the PR § 1.385-3(b) operative rules, but for the threshold exception) *does not exceed $50M*. See PR § 1.385-3(c)(2)

General Rule – "Dividend" Notes

Inbound



Outbound



Inbound

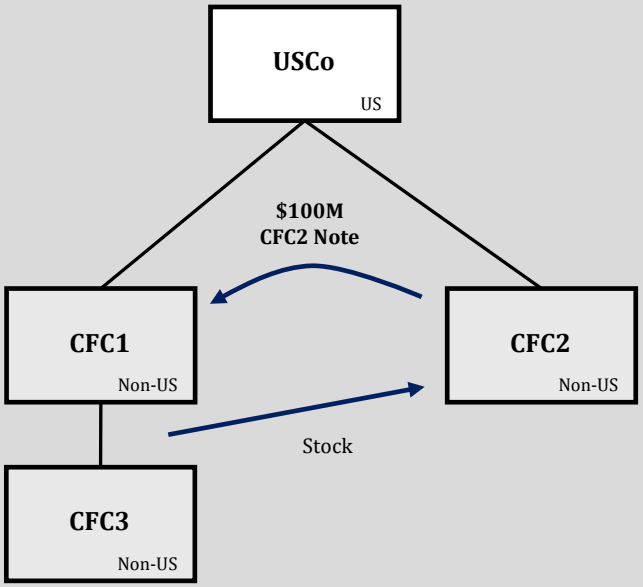
- *Base case* – USCo Note is distribution with respect to USCo stock, and thus recharacterized as distribution of USCo stock; net effect is that interest deduction neutralized, although cash flows potentially subject to dividend WHT?
- *Alternative 1* – what if E&Pc is $100M?
- *Alternative 2* – what if E&Pa is $100M?
- *Alternative 3* – what if E&Pc is $50M?
- *Alternative 4* – what if note is only $50M?

Outbound

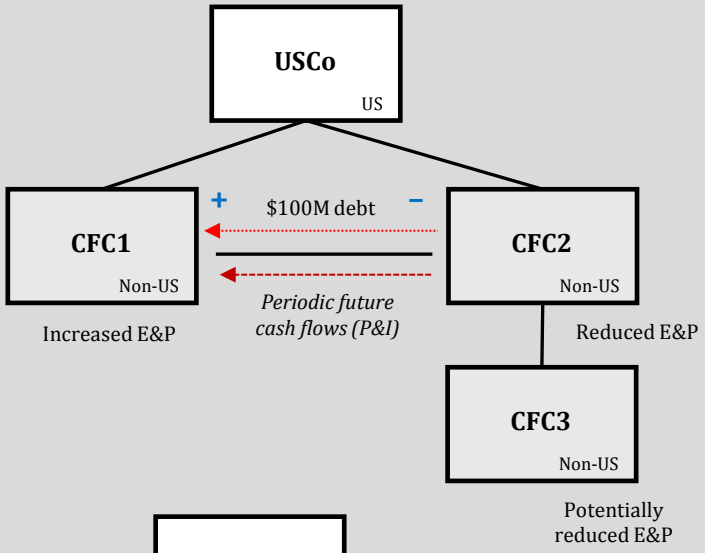
- *Base case* – CFC Note is distribution with respect to CFC stock, and thus recharacterized as distribution of CFC stock; net effect is to potentially neutralize repatriation and interest deduction? FTCs?
- *Alternative 1* – what if E&Pc is $100M?
- *Alternative 2* – what if E&Pa is $100M?
- *Alternative 3* – what if E&Pa is $100M and all in § 959(c)(2) account?
- *Alternative 4* – what if note is only $50M?

General Rule – Debt Issued for EG Stock

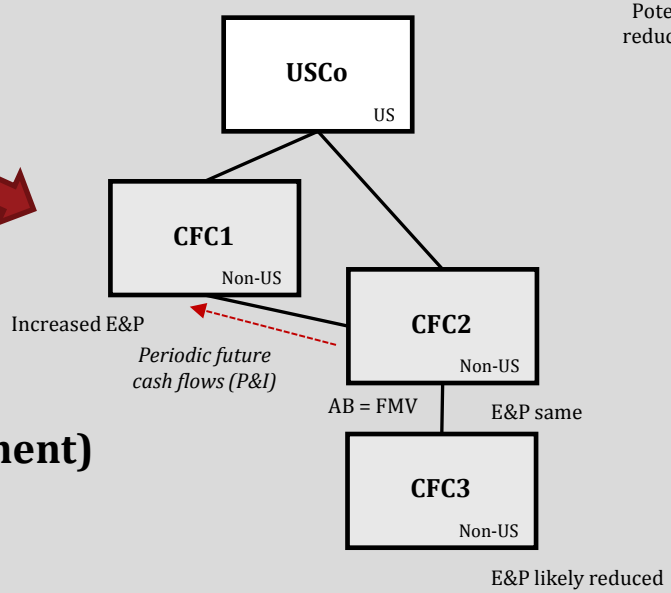
§ 304 transaction



NORMAL



RECAST

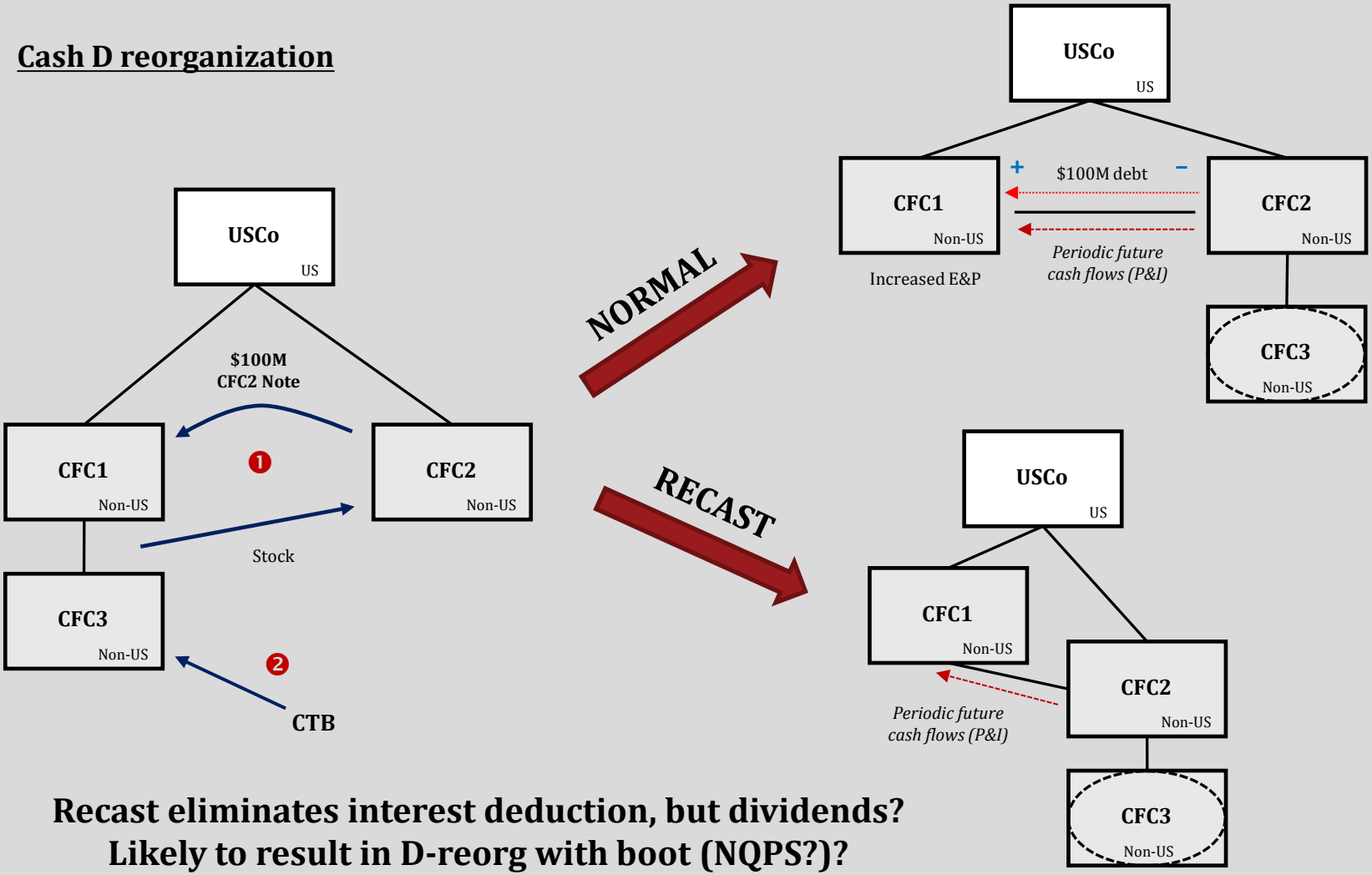


Recast likely results in sale of CFC3
(overriding § 304 to achieve § 1001 treatment)

What if CFC2 has $50M of E&Pc?

General Rule – Internal Asset Reorg

Cash D reorganization



Recast eliminates interest deduction, but dividends?
Likely to result in D-reorg with boot (NQPS?)?

The Funding Rule

Funding rule:

Except as otherwise provided, a **debt instrument** is treated as ***stock*** to the extent it is a **principal purpose debt instrument (PPDI)**

PR § 1.385-3(b)(3)(i)

A debt instrument is a **PPDI** to the extent that it is issued:

(1) by a corporation (the **funded member**) to a member of its EG, in exchange for **property**; and

(2) with **a principal purpose** of funding one or more of the following

(A) a **distribution** of **property** by the *funded member* to a member of its EG (subject to certain exceptions);

(B) an **acquisition** of **EG stock** by the *funded member* from a member of its EG in *exchange* for **property** other than EG stock (again, also subject to certain exceptions); or

(C) an **acquisition** of **property** by the *funded member* in an *asset reorganization* (but only to the extent that a SH that is a member of funded member's EG immediately before the reorganization receives **boot** with respect to its stock in the transferor corporation

PR § 1.385-3(b)(3)(ii)

See next slide

The Funding Rule (cont.)

Principal purpose

- ***Generally*** – whether a debt instrument is issued with a principal purpose of *funding* a *distribution or acquisition* is based on facts/circumstances; does not matter whether the instrument was issued before / after the potentially-problematic distribution / acquisition

- ***Per se rule*** – a debt instrument will be deemed to have been issued with a principal purpose of *funding* a *distribution or acquisition* **if** issued by *funded member during the* ***72 month period*** *beginning 36 months prior to the subject distribution/acquisition*. Non-rebuttable

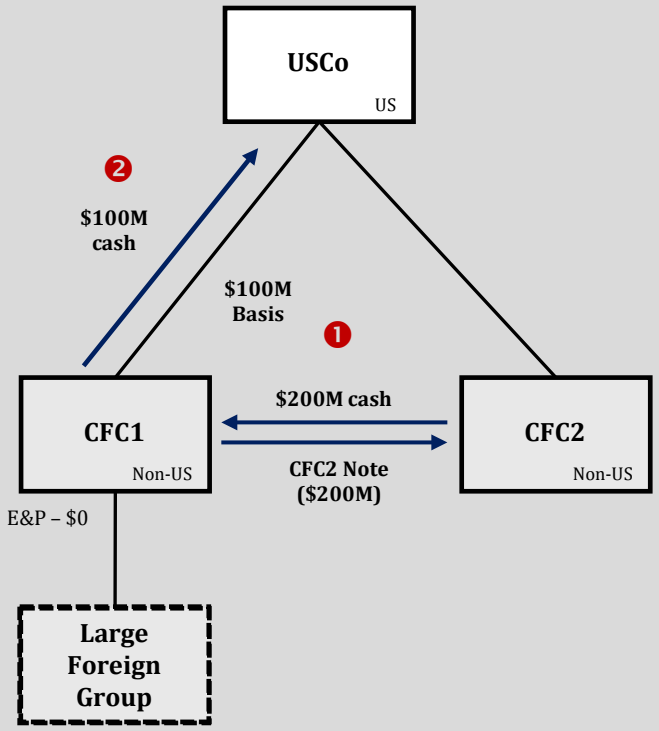
  - ***Ordinary course exception*** – the *per se rule* does not apply to a debt instrument that (1) *arises in the ordinary course of business* in connection with the purchase of property or services, and (2) both (a) it reflects an obligation to pay a currently-deductible amount (or an amount includible in COGS or inventory), and (b) the amount outstanding at no time exceeds the amount necessary to carry on the trade/business of issuer had it been issued to an unrelated lender

- **Issues / concerns with *per se rule***

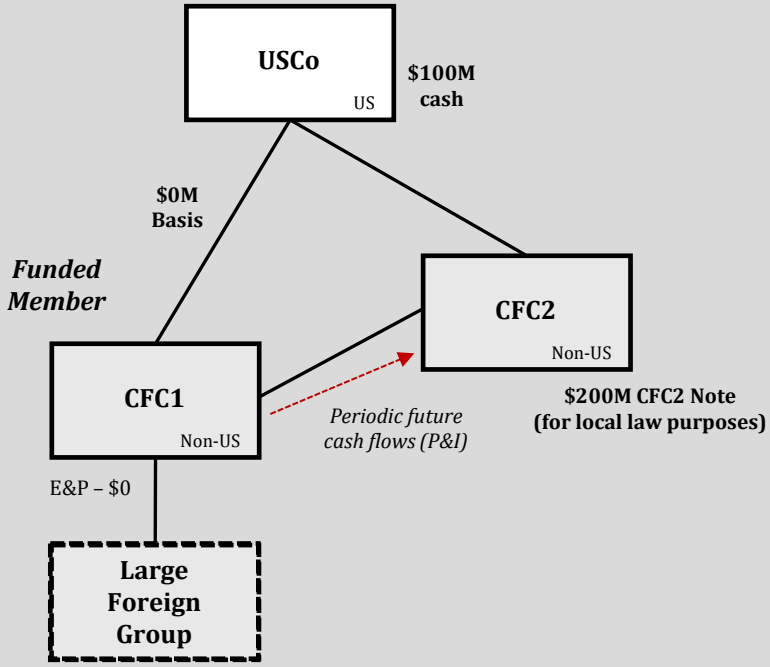
  - Cash pooling arrangements

  - Trade receivables

Funding Rule – Example



Result under *per se* rule



❶ **July, Year 1 – CFC1 borrows $200M from CFC2 for use in various corporate endeavors**

❷ **January, Year 4 – CFC1 distributes $100M in cash to USCo**

Consolidated Groups

Overview

- *CG as one company* – members of a consolidated group are treated as a single corporation; accordingly, intercompany debt within the consolidated group should not be problematic under the rules. See PR § 1.385-1(e)
  - *Larger group still possible* – note that a consolidated group may be foreign-parented, or have non-consolidated affiliates (e.g., CFCs), and thus the § 385 rules will still be applicable in certain scenarios
- PR § 1.385-4 contains additional rules for consolidated groups – the rules here coordinate with PR § 1.385-3 and address situations such as when interests cease or become *consolidated group debt instruments*

Thank you…

J. Brian Davis

BRIAN DAVIS is a partner in the Washington, D.C. office of Ivins, Phillips & Barker. He has practiced in all areas of U.S. federal income taxation, with considerable experience assisting public and private businesses with U.S. corporate tax and global tax planning matters. He regularly serves as a trusted tax adviser to Fortune 100 companies, and has also worked in industry as Director of International Tax for a publicly-traded global media conglomerate. Brian is regularly engaged by corporate, tax and accounting executives seeking proficient and pragmatic advice regarding domestic and cross-border tax structuring and execution matters, and troubleshooting of domestic and international tax issues.

Brian regularly speaks at events sponsored by the Tax Executives Institute, the International Fiscal Association, the American Bar Association and independent finance and accounting/tax executive associations. He also periodically teaches a course on corporate taxation at the George Mason University School of Law. Brian earned his LL.M. in Taxation from New York University School of Law, and his J.D. and B.S. from the University of Oregon.

Partner – Corporate / M&A / International Tax
Washington, D.C.

bdavis@ipbtax.com
O: + 1 202 662 3424
M: + 1 202 445 6855

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Washington, D.C.
Los Angeles, CA

www.ipbtax.com
Washington: + 1 202 393 7600
Los Angeles: + 1 310 551 6633

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