On December 15, the U.S. Congress issued its final version of tax reform via the Conference Report Bill (the “Bill”), which was passed by both Houses of Congress. The Bill represents a compromise of two prior tax reform bills: the Senate’s version issued November 16 and approved on December 2 (the “Senate Bill”) and its counterpart, the House Bill, released on November 2. The Bill was signed into law by President Trump on December 22, 2017.

It is clear from a review of the Bill that its language closely tracks that of the Senate Bill and therefore would effect sweeping, monumental changes to the international tax landscape, largely moving the U.S. corporate tax system to a more territorial system under which the income of a U.S. corporation is taxed to the extent properly allocable to, or “sourced” to, the United States, rather than on a worldwide basis. The key provisions in the Bill are as follows:

- New Participation Exemption Regime
- Deemed Repatriation Tax
- New Anti-Deferral Rules for Global Intangible Low-Taxed Income
- Foreign Derived Intangible Income
- New Constructive Ownership Rules
- Repeal of Indirect Foreign Tax Credit
- Elimination of Active Trade or Business Exception on Property Transfers
- Base Erosion and Anti-Abuse Tax
- Anti-Hybrid Provisions
- Limits on Business Interest Deductions
- Elimination of 30-Day CFC Requirement

- Look-Through Treatment on Sales of Interests in Partnerships Engaged in a U.S. Business
- Sourcing of Sales of Personal Property
Exemption From Subpart F Income for Certain Items
Modification of Section 956
Transfers of Intangible Property From CFCs to U.S. Shareholders

A number of provisions that were in the House or Senate Bill did not get adopted in the final Bill. These and other international provisions are discussed below.

New Participation Exemption Regime

The United States is currently one of the few countries to tax worldwide income. Income earned in foreign subsidiaries is generally exempt from tax until it is repatriated, provided it is not Subpart F income. Generally speaking, this means that the active income of a foreign subsidiary can be deferred from U.S. taxation until the underlying funds are repatriated or deemed repatriated. The United States’ worldwide system of taxation is one of the main reasons that U.S. corporations have largely been moving their tax headquarters to foreign locations through a process known as “inverting.”

In contrast to the U.S. system, most countries have adopted a territorial system under which foreign source income is either not taxed or is taxed at a preferred rate. As an example, Germany will only tax 5 percent of foreign source dividends or gains realized by a German corporation, provided certain ownership thresholds are met. Some other countries exempt such dividends from tax altogether.

This system has been the number one reason companies have inverted to lower tax locations such as Bermuda, Ireland or Switzerland. In response, the Bill effects major changes to the U.S. system of taxation in favor of a system more similar to the type of territorial system that has lured so many U.S. companies offshore.

Like the House and Senate Bills, the Bill introduces a new American Participation Exemption (“Participation Exemption”) with respect to dividends received by a U.S. corporation from foreign subsidiaries. Under the provision, which is contained in new Code section 245A, 100 percent of the “foreign source portion” of dividends paid by a foreign corporation to a U.S. corporate shareholder that both (1) owns at least 10% of the foreign corporation and (2) meets certain holding period requirements would be exempt from U.S. tax. Notably, capital gain on a U.S. person’s sale of the stock of a controlled foreign corporation which is recast as dividend income under Code section 1248 would also be treated as an exempt foreign source dividend for these purposes. To take advantage of the Participation Exemption as to both dividend and capital gain (Code section 1248) income, it will be necessary to meet a 365-day holding period requirement with respect to the stock in the foreign company. Also, a special provision would deny applicability of the Participation Exemption on certain “hybrid dividends,” which would exist to the extent a payment was treated as a dividend in the United States while simultaneously being treated as a deductible payment in the jurisdiction of the payor.

Additionally, and not surprisingly, to prevent a U.S. corporation from receiving a double benefit, no direct or indirect foreign tax credits would be allowed with respect to any exempt dividend.

A special rule under new Code section 961(d) would require that for purposes of measuring loss (but not gain) on the U.S. corporation’s subsequent sale of an eligible foreign subsidiary (i.e., a foreign subsidiary the dividends from which would be eligible for the Participation Exemption), the U.S. company must reduce its basis in the stock of the foreign subsidiary by the amount of distributions exempt from U.S. tax under the Participation Exemption. The reduction under Code section 961(d) would not apply to the extent basis in the stock has already been reduced by virtue of the dividend having been characterized as an extraordinary dividend under Code section 1059.
The Bill would make an exception for Code section 1297 passive foreign investment companies (“PFICs”) that are not also controlled foreign corporations (“CFCs”)—such corporations could not qualify for the Participation Exemption. This would put an increased amount of pressure on the already complicated PFIC analysis, which requires constant testing on a quarterly basis of a foreign corporation’s ratio of passive to active income and assets.

The Participation Exemption would apply to distributions made on or after January 1, 2018.

**Deemed Repatriation Tax**

As a toll-charge for the new territorial system effected by the Participation Exemption, the Bill follows its House and Senate predecessors by adopting a Deemed Repatriation provision, which will automatically tax certain offshore earnings of U.S. multinationals. There can be little doubt that the central focus of this provision was to address the widely publicized issue in the United States of trapped offshore earnings and profits (“E&P”), under which the prohibitively high U.S. corporate rate incentivized such multinationals to leave earnings in offshore lower-tax subsidiaries, thereby gaining a deferral benefit rather than paying current U.S. tax. It was widely reported that this issue has led to as much as almost 3 trillion dollars being “locked out” of the U.S. tax base.

Under the Bill, the deemed repatriation tax would amount, by way of a deduction, to an effective rate of 15.5 percent on cash and cash equivalent positions (specifically, the “aggregate foreign cash position”) and 8 percent on noncash amounts (as opposed to 14.49 and 7.495, respectively, under the Senate Bill and 12 percent and 7 percent, respectively, under the House Bill). To arrive at these percentages, the Bill would incorporate the method advanced in the House Bill whereby the mandatory inclusion would be treated as Subpart F income, and deductions against the mandatory inclusion (e.g., deductions under the Participation Exemption) would be set so as to “back in” to this set rate.

The provision is effected by the modification of Code section 965, which previously addressed the one-time repatriation holiday afforded to U.S. taxpayers through the American Jobs Creation Act of 2004. However, here, this is achieved through the operation of Subpart F. Under the provision, the Subpart F income of such foreign corporation shall be increased by the greater of (1) accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017 or (2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017. The foreign corporation with the deferred income is referred to as a “deferred foreign income corporation.” The amount of a U.S. shareholder’s deficit is reduced by the amount of the U.S. shareholder’s foreign E&P deficit that is allocated to such deferred foreign income corporation.

The provision would apply to specified foreign corporations, which include (1) any CFC and (2) any Code section 902 corporation (colloquially known as 10/50 corporations). However, like the Participation Exemption, it would not apply to any PFICs that are not CFCs.

Foreign tax credits would be disallowed on 71.4 percent of the inclusion in the case of cash and 85.7 percent in the case of noncash property.

An election would be available to take the inclusions into account over 8 years (8 percent per year for the first 5 years, 15 percent in the sixth year, 20 percent in the seventh year, and the remaining 25 percent in the eighth year, in contrast to the analogous House Bill election provision, which would require that each installment payment account for at least 12.5 percent of the total net tax liability).
Notwithstanding the above, a close reading of both the House and Senate Bills suggests that neither was drafted so as to be narrowly tailored to curb the offshore lockout effect as to U.S.-owned corporations. Indeed, the mandatory repatriation provision under both appears to cause mandatory inclusions to certain U.S. individuals as well. This is because, as noted above, both versions of the Bill cause inclusions based on the Code section 951(b) U.S. shareholder definition with respect to “specified foreign corporations.” U.S. shareholders under Code section 951(b) could be either individuals or corporations, and specified foreign corporations for these purposes include both CFCs and so-called “10/50 companies”).

Moreover, because U.S. partnerships are also potential U.S. shareholders for these purposes, small-percentage U.S. interest holders in widely held partnerships could also find themselves subject to mandatory inclusions under Code section 965—a highly counterintuitive result.

The above lends itself to some criticism. On the one hand, the use of the greater of earnings and profits on two measurement dates as opposed to one appears to have been motivated out of a fear that taxpayers would engage in a frantic effort to engage in transactions that would have the effect of reducing earnings and profits prior to that one date. Nonetheless, this “snapshot” method still invites planning and may have the effect of encouraging taxpayers to engage in artificial transactions in the case of income streams received during the interim period between those two dates. As mentioned above, each U.S. shareholder who held a position in the company would be required to pick up the appropriate share of Subpart F income. Further, individuals affected by the mandatory inclusion will be dismayed by the fact that because the rate of tax on the inclusion is determined by a deduction based on the maximum corporate rate (as opposed to the maximum individual rate, which is higher), their effective rate on the inclusion will, in many cases, be higher than that of their corporate counterparts. Under the Bill, individuals in the 39.6 percent individual bracket (the top individual rate in 2017) will see rates of 9.05 percent for noncash positions and 17.5 percent for cash and cash equivalents instead of the 8 percent and 15.5 percent corporate rates mentioned above. These results seem hard to justify. Individuals impacted by this provision may consider certain planning methods in response, including, for example, an election under Code section 962, under which individuals would be taxed as a corporation but would be able to utilize the deemed paid credit on the mandatory inclusion.

In response to some of the criticism received by the House and Senate Bills, the Bill explicitly gives the Secretary the authority to promulgate regulations to make adjustments in E&P to avoid both double-counting and double noncounting, which could be necessary to account for in cases where, for example, a deductible payment is made from one specified foreign corporation to another specified foreign corporation during the interim period between measurement dates (i.e., between November 2, 2017, and December 31, 2017).

New Anti-Deferral Rules for Global Intangible Low-Taxed Income (“GILTI”)

The Bill generally maintains the existing Subpart F regime. In addition, the Bill adds a new category of income to the worldwide anti-deferral regime: Global Intangible Low Taxed Income, with the apt acronym of GILTI. These provisions are contained in new Code section 951A, a part of Subpart F of the Internal Revenue Code, and operate under rules similar to those applicable to Code section 956 inclusions. The amount of the GILTI inclusion is the excess of “net CFC tested income” for the year over “net deemed tangible income return” (i.e., 10 percent of the shareholder’s pro rata share of the aggregate bases of depreciable tangible business property of each CFC with respect to which it is a U.S. shareholder) reduced by interest expense to the extent it is in excess of interest income taken into account when calculating net tested income.
Net tested income for these purposes is essentially the gross income of a CFC, calculated without taking into account certain types of income—specifically, (1) income effectively connected with a U.S. trade or business; (2) gross income taken into account for purposes of determining Subpart F income; (3) high-taxed foreign income within the meaning of Code section 954(b)(4); (4) dividends received from a related person within the meaning of Code section 954(d)(3); and (5) foreign oil and gas extraction income. GILTI appears to be an inclusive category of income. As long as income is not otherwise excluded under the net tested income category, it will be considered GILTI. Thus, notwithstanding the abbreviation, there appears to be no particular requirement that GILTI be related to intangibles, or that the income be low-taxed, for that matter, unless the standard for “low-taxed” is simply that the income is not subject to the “high-tax” exception.

Only 80 percent of the foreign taxes deemed paid by the foreign corporation will be allowed as a credit in determining liability for tax from GILTI. There will also be a completely separate foreign tax credit “basket” for GILTI, with no carryforward or carryback of excess credits related to GILTI, ensuring that the foreign tax credit with respect to GILTI could only be used to offset other GILTI. Income that overlaps as both GILTI and passive basket income would, however, continue to be passive basket income for foreign tax credit purposes.

In connection with the GILTI inclusion, corporate U.S. shareholders would be allowed a deduction for 50 percent of any GILTI under new Code section 250. The net effect of this would be a 10.5 percent “innovation box” that would impose tax on a CFC’s net income that exceeds a routine rate of return on the CFC’s tangible depreciable trade or business assets. The 10.5 percent tax rate would be reduced by a portion of the foreign tax credits paid on the income in question. The rate increases for years after 2025 to 13.125%. The deduction would not appear to be available to U.S. shareholders who are individuals—such persons will presumably have to pick up their full allocable share of GILTI. Perhaps the IRS could address this disparity under its rulemaking authority.

To address concerns raised in connection with this provision under the Senate Bill, the Bill would allow for Treasury to promulgate regulations designed to disregard transactions intended to artificially manipulate tax attributes of CFCs and their U.S. shareholders in order to minimize GILTI.

Foreign Derived Intangible Income ("FDII")

As an incentive to keep low-taxed income within the United States, under new Code section 250, a domestic corporation would also be allowed to deduct 37.5 percent of its Foreign Derived Intangible Income ("FDII"). This would result in an effective tax rate of 13.125 percent on this income, which should be compared to the 10.5 percent rate under the GILTI rules described above. For tax years beginning after 2025, the deduction would be reduced to 21.875 percent, resulting in a tax rate of 16.406 percent. Like the GILTI deduction, this provision is aimed towards minimizing the incentive to operate abroad. Similarly, this provision would not appear to apply to U.S. shareholders who are individuals. Here again, the IRS could address this disparity under its rulemaking authority.

New Constructive Ownership Rules

The Bill would create a new rule that would, for purposes of determining whether a foreign company is a CFC, cause a U.S. corporation to be treated as holding the stock held by a foreign parent that holds at least 50 percent of the stock of the U.S. corporation. The effect of this rule would be to significantly increase the scope of the Subpart F provisions by (1) causing U.S. companies to potentially have Subpart F reporting obligations with respect to brother and sister companies and (2) causing other U.S. investors to be treated as holding stock in a CFC. These changes would be effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of U.S.
shareholders in which or with which such taxable years of foreign corporations end. Additionally, the Bill expands the definition of “U.S. shareholder” under section 951(b) to include “any person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation,” as opposed to the current rule, which looks only to 10 percent voting power. Unlike the constructive ownership change, this would apply to tax years beginning after December 31, 2017.

**Repeal of Indirect Foreign Tax Credit**

Consistent with the policy goals of the new Participation Exemption Regime, the indirect (deemed paid) credit would be repealed under the Bill. The deemed paid credit is the current means of preventing double taxation on dividends to a U.S. corporation from a foreign subsidiary and would normally permit a U.S. corporation to take a credit against its U.S. tax for the foreign taxes on the earnings out of which a dividend from a foreign corporation was paid. Under current law, tax credits can be pooled, thereby facilitating foreign tax credit planning. Pooling would also be eliminated.

**Elimination of Active Trade or Business Exception on Property Transfers**

Generally speaking, when a U.S. person transfers intangible property to a foreign corporation in a nonrecognition transaction (i.e., a transfer of the intangible property in exchange for stock of the foreign corporation), U.S. rules create a deemed royalty stream, which causes the U.S. transferor to have to take into account income over the life of the intangible property. Transfers of property that is not intangible property under the Code section 936(h)(3)(B) definition are, conversely, subject to immediate gain recognition unless such property is used in an active trade or business (“Active Trade or Business Exception”).

In a departure from long-standing regulations, recently issued regulations had provided that outbound transfers of foreign goodwill and going-concern value would be subject to gain recognition under either the immediate-gain recognition standard of Code section 367(a) or the deemed royalty stream construct under section 367(d). Further, under these recent regulations, the section 367(a) Active Trade or Business Exception would only apply to transfers of tangible property. In IRS Notice 2017-38, however, these regulations were identified as imposing an undue financial burden on taxpayers or adding undue complexity to federal tax law.

The Bill would eliminate the Active Trade or Business Exception altogether, thereby ensuring that a transfer of built-in gain property abroad would result in immediate gain recognition to the U.S. transferor irrespective of whether the property was tangible or intangible.

**Base Erosion and Anti-Abuse Tax (“BEAT”)**

The Bill adds section 59A, which would provide for an additional base erosion tax (“BEAT”) designed to further disincentivize corporate taxpayers from “eroding” the U.S. tax base by making deductible payments (including interest expense and royalties) to foreign-related parties. The BEAT would apply only to large corporate taxpayers earning an average of at least $500 million in gross receipts and with a “base erosion percentage” of at least 3 percent during the 3-year period immediately preceding the applicable tax year.

For purposes of the BEAT, all persons treated as a single employer under section 52 would be treated as one person, and for purposes of section 1563, foreign corporations would be included.

The BEAT would be equal to 10 percent (5 percent for 2018 but going up to 12.5 percent beginning in 2026) of the “modified taxable income” of a taxpayer minus the taxpayer’s regular tax liability. In very general terms, a taxpayer’s regular tax liability would be reduced by the amount of credits against such liability minus the total of (1) R&D credits along with (2) 80% of certain other credits provided for under section 38 of the Internal Revenue
Code, subject to a further limitation based on a percentage of base erosion minimum tax. Further, for years beginning after 2025, no section 38 credits would be taken into account in the determination of regular tax liability, thereby adversely affecting taxpayers seeking to take advantage of these credits.

For these purposes, modified taxable income would mean the taxable income of the taxpayer computed under the usual rules but determined without regard to any “base erosion tax benefit” with respect to any base erosion payment or the “base erosion percentage” of any net operating loss deduction.

For these purposes, the “base erosion percentage” would be calculated by dividing the corporation’s base erosion tax benefits (e.g., deductible “base erosion payments”) by the corporation’s total deductions. A “base erosion payment” would generally mean any deductible payment made by the U.S. person to a foreign-related person. The Bill, however, provides a few key exceptions, including (i) a “qualified derivative payment” or (ii) any amount paid or accrued by a taxpayer for services if such services meet the requirements for eligibility for use of the services cost method under applicable U.S. transfer pricing rules, without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure and only if the payments are made for services that have no markup component.

While the BEAT is largely aimed at inbound companies, it will apply to any corporation that makes payments to related foreign corporations, with a decidedly broad standard of relatedness (generally a 25 percent common ownership standard instead of the usual 50 percent). As a result, it could apply to U.S. corporations making payments to foreign subsidiaries. Many U.S.-based multinationals will need to restructure their operations in response to this tax. Moreover, it remains to be seen how this tax will apply in cases where multiple U.S. persons are related to one another but are unable to file a U.S. consolidated return (such as would be the case in a so-called “expanded affiliated group”). In such a case, it is not clear which U.S. entity or entities would be responsible for paying the BEAT liability or how such liability would be allocated among the group members.

Anti-Hybrid Rules

Under anti-hybrid provisions in new Code section 267A, a U.S. corporation would be denied a deduction for certain “disqualified amounts” paid pursuant to a “hybrid transaction,” or by or to a “hybrid entity.” For these purposes, a disqualified amount would be any interest or royalty paid to a foreign person to the extent that under local law (1) there is no corresponding income inclusion to the related party, or (2) such related party is allowed a deduction with respect to such amount. A hybrid transaction for these purposes would be any transaction or series of transactions, agreement or instrument of one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax. This could include payments made by a disregarded entity.

The Bill provides that Treasury will be able to specify in regulations how these rules will apply in cases where the hybrid arrangement involves U.S. or foreign branches rather than actual “hybrid” entities, thereby clarifying a latent ambiguity in the Senate Bill.

This provision would implement certain initiatives discussed under the OECD’s Base Erosion and Profits Shifting (“BEPS”) plans (specifically, “BEPS Action Plan Number 2”) designed to prevent taxpayers from creating “stateless income” through manipulation of discrepancies in the treatment of entities and instruments under the laws of different jurisdictions to create windfalls from associated tax savings. It would also greatly decrease the efficacy of entity classification (check the box) elections in certain international structures.
**Limits on Business Interest Deductions**

The Bill strengthens the current interest expense limitations under section 163(j) by limiting deductions for net business interest expense to 30 percent of adjusted taxable income. Taxpayers with average gross receipts not exceeding $25 million during the three prior tax years would be exempt from the 30 percent limitation, as would taxpayers in certain specified industries, such as certain real estate development, construction and brokerage businesses, which would have the option of electing out of the provision.

For tax years beginning after December 31, 2017, but before January 1, 2022, adjusted taxable income would be calculated without regard to deductions for depreciation, amortization or depletion (i.e., adjusted taxable income would approximate EBITDA); in taxable years beginning on or after January 1, 2022, it would change to EBIT, making it more likely that interest would be disallowed under this provision.

Disallowed interest expense would be permitted as an (unlimited) carryforward and would be a tax attribute that could be carried over in certain corporate acquisitions and other reorganizations.

Notably, the Bill does away with a provision present in both the House and the Senate Bills that would have imposed an additional limitation for taxpayers who were members of an international financial reporting group. Under this limitation, deductions would have been also limited to the extent a U.S. group member’s domestic indebtedness exceeded 110 percent of the indebtedness it would have if its domestic debt-to-equity ratio were equal to that of the entire international financial reporting group.

These provisions would apply to tax years beginning after December 31, 2017.

**Elimination of 30-Day CFC Requirement**

Under current law, in order to be considered a CFC, a foreign corporation needs to meet the applicable “greater than 50% U.S. ownership threshold” during an uninterrupted period of 30 days during a taxable year. The Bill eliminates this requirement, thereby increasing the likelihood that a foreign corporation would be considered a CFC.

The 30-day ownership threshold is a significant source of planning opportunities in the outbound corporate tax sphere, and its elimination will likely expand the reach of the Subpart F anti-deferral rules.

The elimination of the 30-day control requirement for CFC status would go into effect for tax years of CFCs beginning on or after January 1, 2018, and for tax years of U.S. shareholders in which or with which such tax years of CFCs end.

**Look-Through Treatment on Sales of Interests in Partnerships Engaged in a U.S. Business**

A few months ago, the Tax Court made waves in the international tax community by issuing a decision in the *Grecian Magnesite* case. The case effectively overruled Revenue Ruling 91-32, which had stood for the proposition that the sale of an interest in a partnership that is engaged in a U.S. trade or business should be analyzed under an aggregate, as opposed to an entity, theory. As a result, a foreign partner in a partnership that was engaged in a U.S. trade or business would have income effectively connected with that U.S. business merely by virtue of selling the partnership interest.

Under the Bill, the *Grecian Magnesite* decision would be legislatively overruled, returning the tax landscape to the prior status quo. As a result, as before, non-U.S. partners who sell their partnership interest would be
required to report gain as effectively connected income to the extent their distributive share of gain on liquidation of partnership’s assets at fair market value would have resulted in effectively connected income. Further, the purchaser of the partnership interest would be required to withhold 10 percent of the amount realized on such transfers. Under the Bill, regulatory authority is granted to Treasury to allow brokers to withhold this amount on behalf of transferees.

**Sourcing of Sales of Personal Property**

Under current law, under Code section 863, the sale of inventory can be sourced by reference to the place of sale or where title passes. The Bill would change this by revising Code section 863(b) in order to explicitly source income from the production and sale of inventory property solely by reference to the location of production activities. The change would be effective for taxable years beginning after December 31, 2017.

**Exemption From Subpart F Income for Certain Items**

Under current law, certain related-party payments are exempt from Subpart F treatment, provided they are sourced to active business activities outside of the United States. These include interest, rents, royalties and dividends. The provision was first included in the tax law in 2006 on a temporary basis but has been extended on several occasions since enactment.

While under the Senate and House Bills the provision was to become permanent, the Bill did not so provide. The many taxpayers relying on this provision in their international structures will therefore presumably have to continue to nervously await continuation of the provision on a periodic basis once the provision sunsets in 2020.

**Modification of Section 956**

Code section 956 treats certain investments by a controlled foreign corporation in “U.S. property” as a deemed dividend to the foreign corporation’s U.S. owners. The purpose of the rule is to prevent the functional equivalent of a tax-free repatriation of funds to the United States via indirect means (i.e., through investments in the United States or loaning funds to the United States, allowing tax-free use in the United States of offshore funds).

Under the House and Senate Bills, Code section 956 was to be modified to apply only to U.S. individuals. This provision however was not adopted in the Bill. Considering the fact that the Participation Exemption system will now exempt foreign source dividends to U.S. corporations from U.S. tax, it is difficult to understand from a policy standpoint why the Bill would seek to continue to apply Code section 956 to U.S. corporate shareholders.

**Transfers of Intangible Property From CFCs to U.S. Shareholders**

The Senate Bill had also proposed a new Code section 966, which would have made it easier to repatriate intangible property to the United States by reducing the amount of a distribution of intangible property by a foreign corporation to its U.S. corporate owner that would otherwise be taxable to the U.S. owner, but this provision was not ultimately adopted in the Bill.

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