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International High Tech U.S. Tax Current Developments

TEI-SJSU High Tech Tax Institute

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IP Repatriation Regulations

IP Domestication

- On Oct. 9, Treasury and the IRS finalized regulations on the repatriation of IP previously subject to Section 367(d). (TD 9994)
- The regulations terminate the continued application of section 367(d) when
  - A transferee foreign corporation repatriates intangible property to a “qualified domestic person” and
  - Certain reporting requirements are met.
- The regulations would replace portions of the “temporary” Section 367(d) regulations that have been in place since 1986.
- The regulations would generally apply prospectively to IP repatriations occurring on or after October 10, 2024.

IP Domestication

- The final regulations would terminate the application of section 367(d) if the intangible property is repatriated to certain U.S. persons ("qualified domestic persons") that are subject to U.S. taxation with respect to the income derived from the IP.
- Upon repatriation of IP to a qualified domestic person, the final regulations mainly address the following points:
  - How much gain is recognized by the original U.S. transferor?
  - What basis does the qualified domestic person take in the IP?
  - What are the consequences to the transferee foreign corporation?

IP Domestication

- U.S. Transferor's Gain. The U.S. transferor's gain on the IP repatriation depends on whether the IP is transferred basis property as defined in § 7701(a)(43), determined without regard to § 367(d) or the § 367(d) regulations.
    - If the IP is transferred basis property, the U.S. transferor's gain is the amount of gain, if any, the transferee foreign corporation would recognize if its basis in the IP were the U.S. transferor's former adjusted basis.
    - If the IP is not transferred basis property, the U.S. transferor's gain is the excess, if any, of the fair market value of the IP on the date of the subsequent disposition over the U.S. transferor's former adjusted basis in the IP.
- These rules are designed to sidestep uncertainties as to the transferee foreign corporation's basis in the IP.

IP Domestication

- Qualified Domestic Person's Basis. The qualified domestic person's basis following the IP repatriation also depends on whether the IP is transferred basis property.
  - If the IP is transferred basis property, the basis is the lesser of the transferee foreign corporation's basis in the IP or the U.S. transferor's former basis, in each case, increased by the amount of gain, if any, recognized by the U.S. transferor or the transferee foreign corporation due to the subsequent disposition.
  - If the IP is not transferred basis property, the basis is simply the fair market value of the IP.

IP Domestication

- Transferee Foreign Corporation Adjustments**.** If the U.S. transferor is required to recognize gain, the transferee foreign corporation reduces the portion of its E&P and gross income arising from the IP repatriation transaction.
- Other Rules.
    - The final regulations provide rules for the deemed § 367(d) payment in the year of the IP repatriation. The deemed payment rules apply in addition to the rules described above.
    - The final regulations also provide, in general, that the transferee foreign corporation's deemed § 367(d) payment is treated as an allowable deduction, and is properly allocated and apportioned to the appropriate classes of gross income under certain specific applicable rules.
    - Related Transactions: If there is a series of related transactions, the initial transferee is treated as a qualified domestic person only if the ultimate recipient of the IP is a qualified domestic person.

IP Domestication Reporting Requirements

- U.S. transferor must provide information required under Treas. Reg. § 1.6038B-1(d)(2)(iv)
- If the U.S. transferor failed to provide that information, it can still be eligible for relief under these rules if the U.S. transferor, upon becoming aware of the failure,
  - promptly provided the required information,
  - provided a reasonable explanation for its failure to comply, and
  - met certain other requirements (if applicable).
- The addition to the proposed regulations is that the final regulations also only provide relief for failure to report if
  - the U.S. transferor timely filed one or more amended returns for the taxable year in which the subsequent transfer occurred and the succeeding years, and
  - if the U.S. transferor is under examination when an amended return is filed, it provides a copy of the amended return(s) to the IRS personnel conducting the examination.

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CAMT International Aspects

CAMT Overview

- For tax years beginning after 12/31/22, an applicable corporation is subject to the corporate alternative minimum tax (CAMT) to the extent of the excess of its tentative minimum tax over its regular tax liability
- In general, an applicable corporation is a corporation other than a RIC, REIT, or S corp that, for any prior 3 taxable year period that includes a tax year ending after 12/31/21, averages $1B or more of adjusted financial statement income (AFSI)
  - AFSI is the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement (as defined in section 451(b)(3)) (AFS) for such taxable year, adjusted as provided in section 56A
  - For purposes of this threshold test, AFSI of members of the same controlled group under section 52 are aggregated
  - Special scoping rule for foreign-parented groups requires $1B "global" AFSI and $100m US AFSI
  - Once an applicable corporation, always an applicable corporation
- Tentative minimum tax = 15% of AFSI reduced by CAMT foreign tax credits
- Regular tax liability = regular U.S. taxes (including BEAT) reduced by foreign tax credits (but not section 38 general business credits)

Proposed CAMT Regs

- Proposed CAMT regulations were issued in September 2024. They incorporate and elaborate on various pieces of interim guidance (Notice 2023-7, Notice 2023-20, Notice 2023-64, and Notice 2024-10)
    - The proposed regulations are generally consistent with the interim guidance in Notice 2024-10 and would require taxpayers to rely on existing "regular tax rules" with respect to CFCs within CAMT for determining the E&P of foreign corporations and the basis of the stock of foreign corporations.
- A CAMT entity is required to disregard any items of income, expense, gain, and loss resulting from ownership of the stock of a foreign corporation reflected in the CAMT entity's financial statement income ("FSI").
- A CAMT entity would be required to include in AFSI any items of income, deduction, gain, and loss for regular tax purposes resulting from ownership of stock of the foreign corporation. See discussion of a CFC's pro rata share of ANI below.

Proposed CAMT Regs

- These adjustments would be expected to prevent double counting in many cases.
  - E.g., the AFSI of a CAMT entity would generally not reflect any inclusion with respect to a distribution of PTEP by a foreign corporation because the item of FSI with respect to the distribution would be disregarded and section 959(a) excludes the regular tax amount of the distribution of PTEP from the CAMT entity's gross income
- Note, CAMT retained earnings are not relevant in determining AFSI in respect of ownership of stock of foreign corporations.

Proposed CAMT Regs—Ownership of Foreign Corps

- As one illustration of the proposed regulations, the AFSI of a CAMT entity that is a domestic corporation would not reflect any inclusion with respect to a dividend received from a foreign corporation if the CAMT entity is eligible for a dividends-received deduction under section 245A for the entire amount of the dividend, because the item of FSI with respect to the dividend would be disregarded, and the regular tax income item with respect to the dividend would be offset by an item of deduction resulting from the receipt of the dividend.
- As another example, the AFSI of a CAMT entity that is a domestic corporation would generally not reflect any inclusion with respect to a distribution of previously taxed earnings and profits (PTEP) (described in section 959 of the Code) by a foreign corporation to the CAMT entity because the item of FSI with respect to the distribution would be disregarded and section 959(a) excludes the regular tax amount of the distribution of PTEP from the CAMT entity's gross income.

Proposed CAMT Regs—Distributions from CFCs

- In determining the amount included in AFSI of a U.S. Shareholder of a CFC resulting from a Covered CFC Distribution received with respect to stock of the CFC, AFSI of the U.S. Shareholder is determined by—
  - (1) Disregarding any items reported on the U.S. Shareholder's AFS resulting from the receipt of the Covered CFC Distribution; and
  - (2) Including the U.S. Shareholder's items of income and deduction under chapter 1 (for this purpose, taking into account § 959(d) and excluding §§ 56A and 78) resulting from the receipt of the Covered CFC Distribution.

Proposed CAMT Regs—Distributions from CFCs

- In determining the Adjusted Net Income or Loss of a CFC resulting from a Covered CFC Distribution received with respect to stock of another CFC, Adjusted Net Income or Loss of the recipient CFC is determined by—
  - (1) Disregarding any items reported on the recipient CFC's AFS resulting from the receipt of the Covered CFC Distribution; and
  - (2) Including the recipient CFC's items of income under chapter 1 (excluding § 56A) resulting from the receipt of the Covered CFC Distribution, determined without regard to any exclusion under chapter 1 (for example, § 954(b)(4)), and then reduced to the extent the Covered CFC Distribution is excluded from—
    - (a) Both—
      - (i) The recipient CFC's foreign personal holding company income under § 954(c)(3) (relating to certain income received from related persons) or § 954(c)(6) (relating to certain amounts received from related CFCs); and
      - (ii) The recipient CFC's gross tested income under § 1.951A-2(c)(1)(iv)(relating to dividends received from related persons); or
    - (b) The recipient CFC's gross income under § 959(b).

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DCL Proposed Regulations

Proposed DCL Rules – Overview

- Proposed dual consolidated loss (DCL) regulations cover:
  - Intercompany transactions and items arising from stock ownership in calculating a DCL
  - DCL rules and Pillar 2
  - Disregarded payments that give rise to losses for foreign tax purposes
- The regulations are generally proposed to be effective for taxable years ending on or after August 6, 2024
  - DCL rules relating to intercompany transactions are proposed to be applicable after the regulations are finalized, but allow a taxpayer to then elect to apply these proposed regulations to previous taxable years that remain open if applied consistently by the consolidated group.

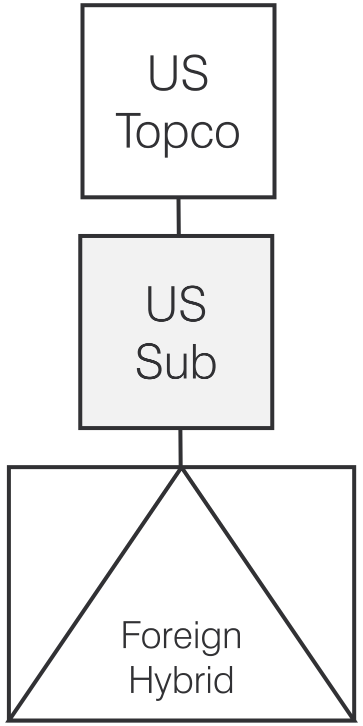
DCL Background

- Section 1503(d)(2)(A): A DCL is any net operating loss of a dual resident corporation or the net loss of a domestic corporation attributable to a separate unit subject to foreign income tax
  - A dual resident corporation is a domestic corporation that is subject to income tax in a foreign country on its worldwide income or on a residence basis
  - A separate unit is either a foreign branch or an interest in a hybrid entity
- DCL rules generally provide that a DCL of a domestic corporation cannot reduce the taxable income of a domestic affiliate ("domestic use") Sec. 1503(d)(1) and Treas. Reg. Sec. 1.1503(d)-1
- For US tax purposes, a separate unit is generally attributed items to the extent that it is likely that the item is taken into account for foreign tax purposes, which is needed to determine if there will be a double-deduction result.

DCL Background – Foreign Use

- The DCL limitation doesn't apply if a domestic use election is made to certify that there has not been and will not be a "foreign use" of the DCL during a certification period. Treas. Reg. Sec. 1.1503(d)-6
  - A foreign use occurs when *any potion* of the DCL is "made available" under foreign income tax laws to offset or reduce (directly or indirectly) income of a foreign corporation or the owner of a hybrid entity that is not a separate unit.
  - If a foreign use or other triggering event occurs, the DCL must be recaptured with an interest charge.

DCL Example



- Assume Foreign Hybrid is disregarded for US tax purposes but is treated as opaque in its jurisdiction of incorporation (thus subject to tax there on a residence basis)
- Assume US Sub has an NOL as a result of the operations of Foreign Hybrid
- Under the statute, unless the loss does not offset the income of any foreign corporation, it cannot be used to reduce the taxable income of US Topco
- US Topco can use the NOL if there is a domestic use election certifying that there has not been and will not be a foreign use within the certification period

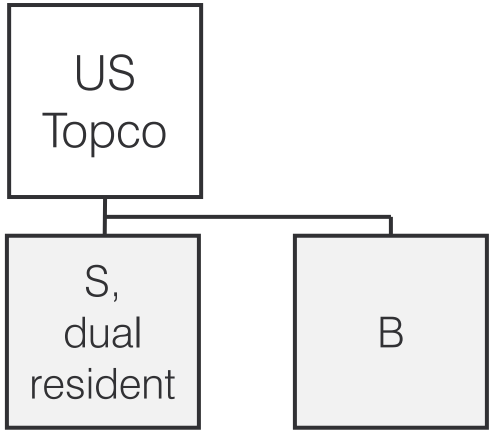
Pillar Two Rules – Background

- GloBE Model Rules: an in-scope MNE Group must compute the GloBE Income or Loss of each of its Constituent Entities using the account standard used in preparing the Consolidated Financial Statements and without consolidation adjustments that would eliminate income or expense attributable to intra-group transactions, with further adjustments.
- The MNE Group must calculate its Effective Tax Rate (ETR) for each jurisdiction, considering the income or loss of all entities located in that jurisdiction.
- Notice 2023-80: legacy DCLs (for a tax year ending on or before December 31, 2023) would not be treated as having "foreign use" if they are taken into account in determining the net GLOBE income in a GLOBE year under Pillar Two.

Proposed DCL Rules – Intercompany Transactions

- Prop. Reg. § 1.1502-13(j)(10) (governing intercompany transactions) would provide that
  - If
    - an affiliated dual resident corporation or an affiliated domestic owner acting through a separate unit (a "section 1503(d) member"),
    - That has intercompany or corresponding loss that would be taken into account in the current year, and
    - The DCL rules apply to cause the loss not to be currently deductible,
  - Then the -13 regs would not redetermine that loss as not being subject to the DCL rules.
- Overall: a dual resident corporation or separate unit's loss follows the DCL rules, not the -13 rules even if it is inconsistent with single entity treatment.
- This rule does not apply to the counterparty; -13 rules continue to apply.

Example: matching rule first, DCL second



- Year 1: S, a section 1503(d) member subject to a domestic use limitation, sells inventory property to B for $60 and recognizes a $40 loss because of $100 basis. Loss is not taken into account under matching rule.
- Year 3: B sells the property to nonmember X for $110, a $50 gain for B. Normally, S would take the $40 loss into account under the matching rule and B would take the $50 gain into account. B's gain is taken into account, but not S's loss.
- Same treatment would apply if S were a domestic owner of a branch and the branch sold the property to B.

Proposed DCL Rules – Intercompany Transactions

- The proposed regulations generally provide that items arising from the ownership of stock are not taken into account for purposes of computing income or a dual consolidated loss
  - gain recognized on the sale or exchange of stock,
  - dividends (including by reason of section 1248),
  - subpart F inclusions (including hybrid and 964(e)(4) dividends),
  - GILTI inclusions, and
  - deductions with respect thereto
- This rule is turned off for portfolio stock (< 10% ownership by value)
- Preamble admits this could lead to two levels of tax with no offsetting deduction under either the US or foreign tax system

Proposed DCL Rules – Entity's Books & Anti-Avoidance

- Regarded items of a domestic owner generally are attributable to a hybrid entity separate unit to the extent they are reflected on the books and records of the hybrid entity
  - Adjustments must be made to conform to US tax accounting
  - However, those adjustments generally cannot include attributing income to the hybrid entity if the income does not appear on the entity's books (limited exceptions)
- Broad Anti-Avoidance Rule in Prop. Reg. § 1.1503(d)-1(f))
  - If a transaction, series of transactions, plan, or arrangement is engaged in with a view to avoid the purposes of section 1503(d) and the regulations in this part issued under section 1503(d), then appropriate adjustments will be made."
  - Covered transactions include ones "engaged in with a view to reduce or eliminate a [DCL] or a disregarded payment loss while putting an item of deduction or loss that composes (or would compose) the [DCL] or disregarded payment loss to a foreign use."

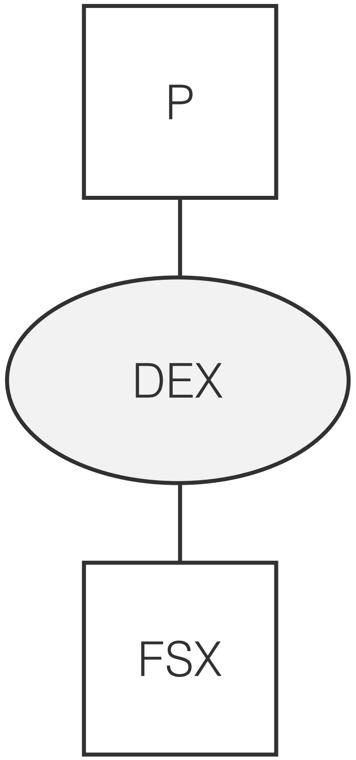
Proposed DCL Rules & Pillar Two

- The proposed regulations add a transition rule: the DCL rules apply without taking into account QDMTTs or Top-up Taxes for losses incurred in taxable years beginning before August 6, 2024, subject to an anti-abuse rule.
- Prop. Treas. Reg. Sec. 1.1503(d)-1(b)(6)(ii) treat Pillar 2 top-up taxes as income taxes
  - IIR or QDMTT may be an income tax under DCL rules and a foreign use may occur if a loss is used in the calculation of Net GloBE Income or to qualify for a Transitional CbCR Safe Harbour.
- No specific UTPR guidance provided in the proposed regulations.
- A domestic entity is not treated as a dual resident corporation or a hybrid entity solely as a result of the domestic entity's income or loss being taken into account in determining the amount of an IIR.
- Generally, if a consolidated group has two or more separate units located in or subject to an income tax in the same foreign country, those units are treated as one separate unit.

Proposed DCL Rules & Pillar Two

- Treasury and the IRS determined that generally there will not be an exception to foreign use under the Transitional CbCR Safe Harbor (but see below limited exception)
  - Transitional CbCR Safe Harbor, applicable to financial years beginning before December 31, 2026, which provides a path out of application of top-up tax in a jurisdiction, sometimes involves pooling of income and losses of constituent entities in the same jurisdiction and therefore could be a foreign use of a DCL.
- However: a limited exception applies to the Transitional CbCR Safe Harbor
  - There is deemed to be no foreign use for DCL purposes under the GloBE Model Rules where the Transitional CbCR Safe Harbor is satisfied and the rules addressing duplicate loss arrangements under Transitional CbCR Safe Harbor prevent foreign use (proposed Treas. Reg. Sec. 1.1503(d)(-3(c)(9)).

Pillar Two Example

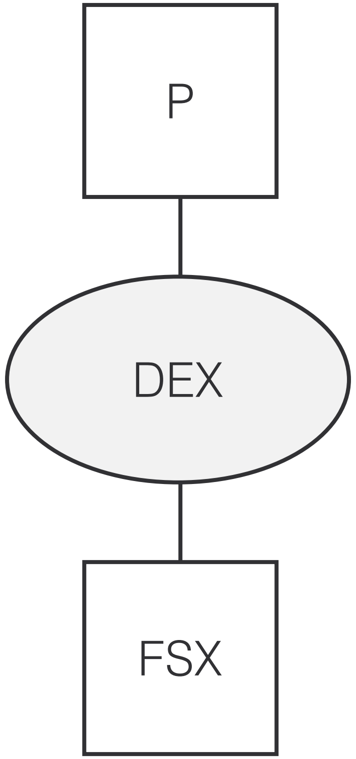


- Country X imposes no income tax other than a QDMTT
- DEX incurs a $100 interest deduction, reflected on its books
- If the $100 expense were deducted by P for US tax, it would be a Duplicate Loss Arrangement (DLA) and would be excluded from Country X profit/loss before income tax for purposes of the safe harbor under Country X DLA rules. Because it is excluded, the safe harbor is not satisfied.
    - [If the $100 were not excluded, the safe harbor would be satisfied. The Country X DLA rules apply only for purposes of the safe harbor.]
- Result: DEX is a hybrid entity, P's interest in DEX is a hybrid separate unit, and the $100 deduction gives rise to a DCL.
- The DCL would be put to a foreign use because the Country X DLA rules apply only for purposes of the safe harbor. No domestic use election is available.

Proposed DCL Rules – Disregarded Payment Losses

- The proposed regs add a new set of rules for “Disregarded Payment Losses” (DPLs)
- A DPL arises where a disregarded entity (1) makes a disregarded payment to the U.S. parent of interest, royalties, or a similar financing type of payment and (2) generates a non-U.S. taxable loss.
  - No US deduction (disregarded payment) so not a DCL
- On a foreign use of deductions underlying a DPL by a person related to the domestic owner or other triggering events, the US taxpayer would be required to <u>include</u> a notional amount of <u>gross income</u> necessary to recapture the DPL (“DPL inclusion amount”).
  - Has the same source and character as a regarded payment from a CFC would.
  - An “all or nothing” concept; triggered income may be far in excess of the amount of the DPL actually used to reduce a CFC’s foreign taxes.
- DPL certification period is any foreign tax year up to and including the year of the payment, plus the subsequent 60 months.

Proposed DCL Rules – DPL Example



- P is domestic corporation and DEX and FSX were formed in the same foreign country (X).
- DEX has $100x of interest expense on a loan from P, which is disregarded for U.S. tax purposes.
  - Under a foreign law consolidation regime, FSX may use the net operating loss of DEX for local income tax purposes.
- DEX would have a DPL because:
  - DEX has a loss for country X tax purposes stemming from a disregarded payment, which is deductible for local tax purposes;
  - The disregarded payment, if regarded for U.S. tax purposes, would be characterized as interest, a royalty or other similar financing transaction; and
  - This disregarded payment loss arose while DEX was a separate unit subject to the DCL rules.
- P must include $100 of phantom "DPL inclusion income."

Proposed DCL Rules – DPL Rules Effective Date

- The new DPL rules are effective immediately (taxable years ending after Aug. 6, 2024), but have a one-year grace period for existing disregarded entities (DREs).
  - Taxpayers would be required to consent to the DPL rules when they make new check-the-box elections, or acquire or form an eligible entity that defaults to DRE status.
  - Taxpayers with pre-existing DREs would be deemed to consent to the DPL rules, beginning on August 6, 2025

- Questions regarding DPL rule validity, including consent procedure

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Section 988 Proposed Regulations

Sec. 988 Prop. Regs.

- 2024 proposed foreign currency regulations address section 988 gains and losses and related CFC elections under section 954(c)(1)(D) (REG-111629-23 (August 20, 2024)).
- Section 954(c)(1)(D) and reg. section 1.954-2(g) provide that foreign personal holding company income (FPHCI) includes any section 988 excess foreign currency gains over foreign currency losses.
- Under reg. section 1.954-2(g)(3) and (4), two elections are available to a controlling U.S. shareholder in computing its CFC's FPHCI.
  - Reg. section 1.954-2(g)(3) election: the U.S. shareholder can elect to exclude a CFC's foreign currency amount from FPHCI and instead include it in the shareholder's subpart F income based on the category (or categories) to which the foreign currency gain or loss relates.
  - Reg. section 1.954-2(g)(4) election, the U.S. shareholder can elect for all foreign currency gains or losses attributable to any section 988 transaction to be treated as FPHCI, with certain exceptions.

2017 Sec. 988 Prop. Regs.

- Under the 2017 proposed reg. section 1.988-7 regulations,
  - Reg. section 1.954-2(g) elections could be revoked at any time, but if the election is revoked, a new election cannot be made for five years.
    - Taxpayers could rely on these rules for tax years ending on or after December 19, 2017, subject to a consistency requirement.
  - A CFC could also elect to use a mark-to-market method of accounting for any section 988 gain or loss on certain transactions under reg. section 1.988-7.
    - This election is made on the elected year's timely filed original tax return and has similar reliance, consistency, and revocation rules to the reg. section 1.954-2(g) election.

2024 Sec. 988 Prop. Regs.

- 2024 proposed regulations initially disallowed a reg. section 1.988-7 mark-to-market election if the tax return was filed on or after August 19, 2024, but not if the tax return was filed before these regulations were published on August 19.
  - The MTM election could be made only on an originally filed tax return for the year immediately preceding the year to which the election applies.
- Further, although the new regulations are proposed to apply to tax years ending after finalization, they provide that taxpayers may no longer rely on the 2017 proposed regulations as of August 19, 2024.
- September 4 corrections allow for taxpayers to make the reg. section 1.988-7 mark-to-market election for 2023 and 2024 calendar years on those originally filed returns rather than prospectively.
  - The prospective election rules would then apply for future years.
- 2024 proposed regulations were revised so that a controlling U.S. shareholder would be precluded from revoking a reg. section 1.954-2(g) election made on behalf of a CFC (including an initial election) for five tax years.
  - The prior proposed regulations allowed for the election to be revoked at any time.

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Resurgence of the Economic Substance Doctrine

ESD – Background

- Longstanding judicial doctrine generally required:
  - Meaningful change in economic position aside from federal tax.
  - Substantial purpose aside from federal income tax reasons.
- In 2010, § 7701(o) codified the doctrine: In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

  (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

  (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.
- Section 7701(o)(5)(C) provides that the determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if § 7701(o) had never been enacted.

ESD – Background (cont.)

- H.R. Rep. No. 111-443, Vol. I, at I-291.
  - The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are
    - (1) the choice between capitalizing a business enterprise with debt or equity;
    - (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
    - (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and
    - (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

Economic Substance Penalties

- Strict liability penalty of 20% of any underpayment amount for any transaction that lacks economic substance or fails to meet the requirements of any similar rule of law. Section 6662(b)(6).
- The 20% penalty increases to 40% for any underpayment which is attributable to an undisclosed transaction. Section 6662(i).
- No reasonable cause exceptions. Sections 6664(c)(2) and 6676(c).
- Section 7701(o) and the related strict liability accuracy-related penalty apply to transactions entered into after March 30, 2010.

ESD – Exam

- On April 22, 2022, the IRS issued interim guidance that it is eliminating the requirement of executive approval for raising economic substance and related penalties. LB&I-4-0422-0014.
- The penalties must be timely approved in writing by the immediate supervisor of the person who initially determines the penalty applies in order to comply. Section 6751(b).
- The examiner must consult with local field Counsel before proceeding if the issue/case is novel and/or significant or the issue has required or will require significant resources to address.

Treasury Inspector General for Tax Administration (TIGTA) Report

- Aug. 26, 2024 TIGTA report recommended that:
  - The IRS review its examination procedures to determine whether changes are needed in support of effective tax administration for large complex taxpayers, to which the IRS agreed. This includes, but is not be limited to,
    - the use of the Economic Substance Doctrine,
    - Principles of Collaboration between taxpayers and the IRS, and
    - the CAP program.
  - Appeals update its policies to require inviting compliance personnel and Counsel to taxpayer conferences involving large multinational corporations, to which the IRS did not agree as Appeals should make that decision on a case-by-case basis.
- The report was spurred by an IRS employee
  - Questioning the IRS's efforts to raise ESD relating to a specific foreign trust structure used by multiple large multinational corporations; and
  - Citing concerns of undue influence on IRS policies and procedures facilitated by the revolving door and influence that the largest law and accounting firms have on the IRS.
- Concerns were raised that some large multinational corporate taxpayers may not be suitable for the IRS's CAP program and it was difficult to remove taxpayers.

Liberty Global ESD – Overview

- Liberty Global challenged the government's disregard (under the economic substance and step transaction doctrines) of the tax consequences of a restructuring that included an entity conversion.
- DOJ asserted that Liberty Global undertook a "series of highly engineered related-party transactions" to avoid tax.
- On Oct. 31, the US District Court for the District of Colorado held for the government under ESD.
  - Result is $2.4B in gain.
  - As a result, the court did not address the step transaction doctrine.
- Under Appeal to the 10th Circuit.

Liberty Global ESD – Facts

- Transaction overview (simplified):
  - US corporation owned multiple Belgian entities
  - Preliminary steps, including creation of debt between the parties
  - The entity conversion at issue was of a Belgian limited liability company ("BVBA") into a Belgian "Naamloze vennootschap/Société anonyme" ("NV/SA"). This is similar to an LLC converting into a corporation.
- Liberty Global claimed a § 245A DRD on the subsequent sale of the CFC, which was treated as a dividend.
- Liberty Global asserted that ESD is not relevant to the entity conversion. It analogized the conversion to entity classification elections which are authorized by Treasury Regulations even though they have only tax effects.
- The government looked beyond the single entity conversion step and argued that the transaction as a whole had no economic substance in creating non-taxable E&P.

Liberty Global ESD – Opinion

1. The court determined that ESD is “relevant” to Liberty Global’s transaction.
    - The court looked to the House Report that stated, “the economic substance doctrine becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.” H.R. Rep. No 111-443, 292.
    - The court then stated that this statement “suggests that the doctrine’s relevance is coextensive with the statute’s test for economic substance [in] the operative clause.”
    - The court then concluded that there is no threshold relevance inquiry that precedes the inquiry in the operative clause of the statute; that is, there is no threshold inquiry separate from the two statutory factors.
    - The court stated that its “conclusion [is] that the economic substance doctrine applies when a transaction lacks economic substance.”

Liberty Global ESD – Opinion (cont.)

2. The court determined that the “transaction” to be analyzed under the ESD is not just the LLC to C corporation conversion, but the conversion combined with other relevant steps.
   - The court rationalized that it had authority to aggregate or disaggregate interrelated transactions.
3. The court considered whether the transactions were exempted from the ESD either explicitly or by analogy to statutorily enumerated exceptions.
   - The same House Report provides that basic business transactions are exempt from the ESD.
   - The court determined that the Liberty Global transaction was not a basic business transaction as the House Report describes.

Liberty Global ESD – Opinion (cont.)

4. The court analyzed both prongs of the ESD test to determine that the ESD applied to LGI's transaction.
    - The court determined that the non-tax consequences of the transaction were insufficient to meaningfully change LGI's position.

- <u>Holding</u>: the court disregarded the steps creating the "non-economic" E&P in the section 351 transaction so that the subsequent sale of the CFC resulted in taxable gain rather than a section 245A DRD.

Liberty Global ESD – LGI 10th Circuit Brief

- LGI filed an appeal to the 10th Circuit.
- LGI argued that:
  - IRS cannot rely on ESD to contravene the Code.
  - ESD in not relevant because section 7701 "doesn't authorize using the doctrine to deny LGI's 245A deduction".
  - "The economic substance doctrine can be relevant only when there is a dispute about whether the taxpayer actually has in substance what a Code provision requires."
  - The doctrine isn't relevant when the taxpayer actually has what it claims—real gain.

Liberty Global ESD – Amicus Briefs

- Focus on the misapplication of 7701(o) by reading relevance standard out of the law.
- Decision cannot be reconciled with the unambiguous statutory text.
  - The statutory clause "to which the economic substance doctrine is relevant" would be rendered meaningless.
- Violates congressional intent.
- Predictable tax laws are critical to fostering cross-border investment.
- The ESD should be used only in a narrow category of cases, or it would undermine entirely any certainty and predictability in the code.
- The ESD is not a vehicle allowing the IRS or the courts to correct perceived flaws or loopholes in the tax law.
- Infringes on the proper role of the legislative branch.
- The doctrine does not provide the IRS or the courts a backdoor tool to correct perceived legislative errors or to retroactively effectuate a different tax policy objective.
- Because of stiff penalties, it is particularly important to properly apply the relevance screen.

Chemoil ESD

- IRS challenged on economic substance grounds Chemoil's entitlement to a refundable credit for qualifying alcohol fuel mixtures under section 6426(b).
- Under a single contract, Chemoil:
  - purchased ethanol from an unrelated party,
  - mixed the ethanol with small amounts of gasoline, and
  - sold the mixture back to the same unrelated party for 40-cents per gallon less than the initial purchase.
- Taking into account the 45-cent credit, Chemoil netted a 5-cent profit per gallon.
- Southern District of New York denied Chemoil's refundable credit due to lack of economic substance.
- Rejected Chemoil's argument, based on section 7701(o) legislative history, that the economic substance doctrine does not apply where a taxpayer undertakes the type of activity that the tax benefit/credit was intended to encourage.
- If not for the tax credit, Chemoil had no reasonable expectation of a profit because Chemoil purchased ethanol and resold it for a 40-cent loss per gallon.

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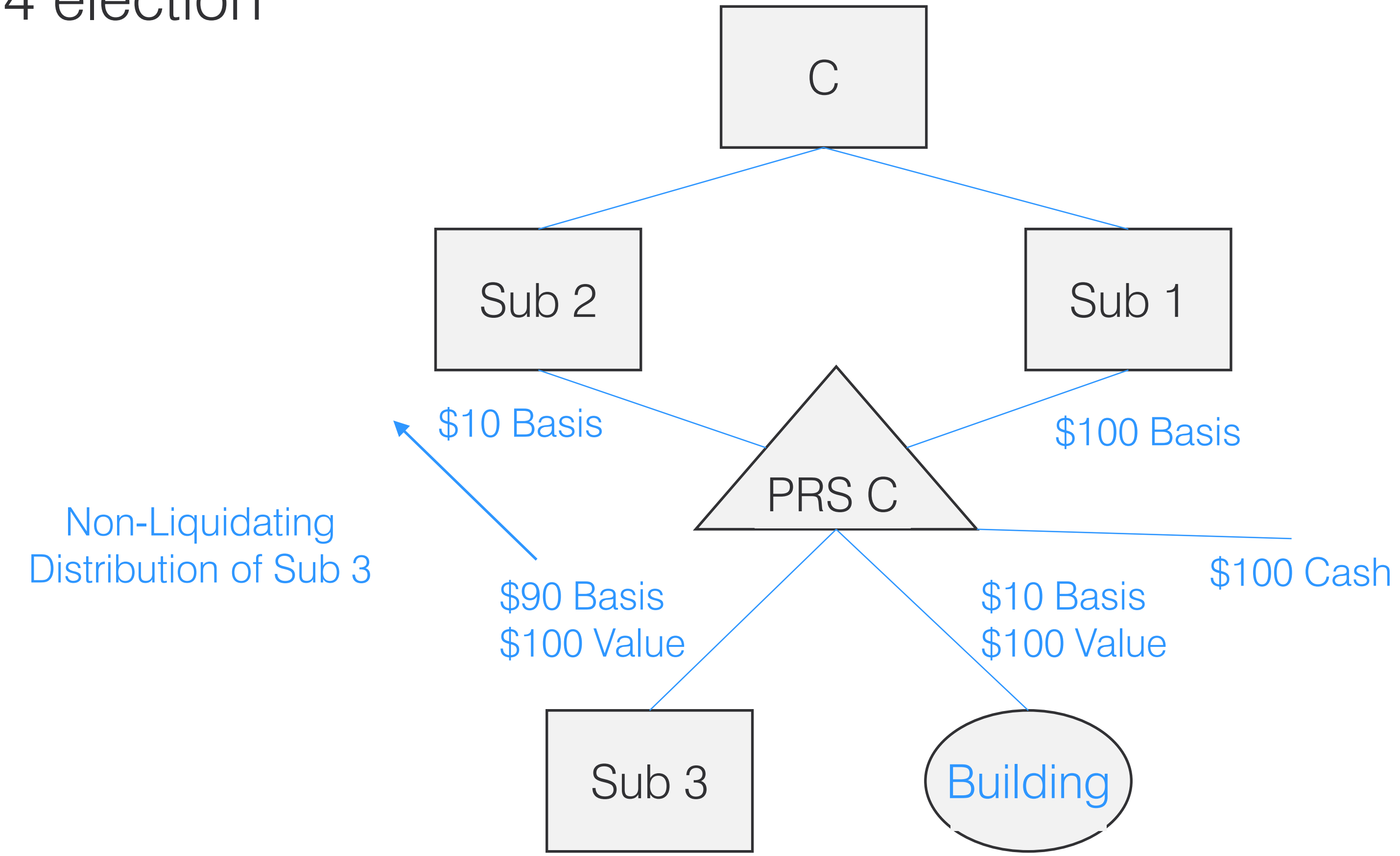
New Guidance on Partnership Basis Shifting Transactions

Basis Shifting Guidance

- The IRS issued three sets of guidance to correct perceived abuses in the basis adjustment rules of subchapter K involving related-party partnerships:
  - Rev. Rul. 2024-14: asserting that basis adjustments in three illustrative fact patterns lack economic substance and can be disregarded on that basis (plus penalties under Section 7701(o))
  - Notice 2054-54: proposal to put Revenue Ruling in the form of Proposed Regulations
  - Proposed Regulations 124593-23: proposal to make transactions described in Rev. Rul. 2024-14 "transactions of interest" subject to tax shelter reporting
- Proposed regulations and Notice purport to be "prospective," but are effective for tax benefits claimed today from transactions effected in the past.

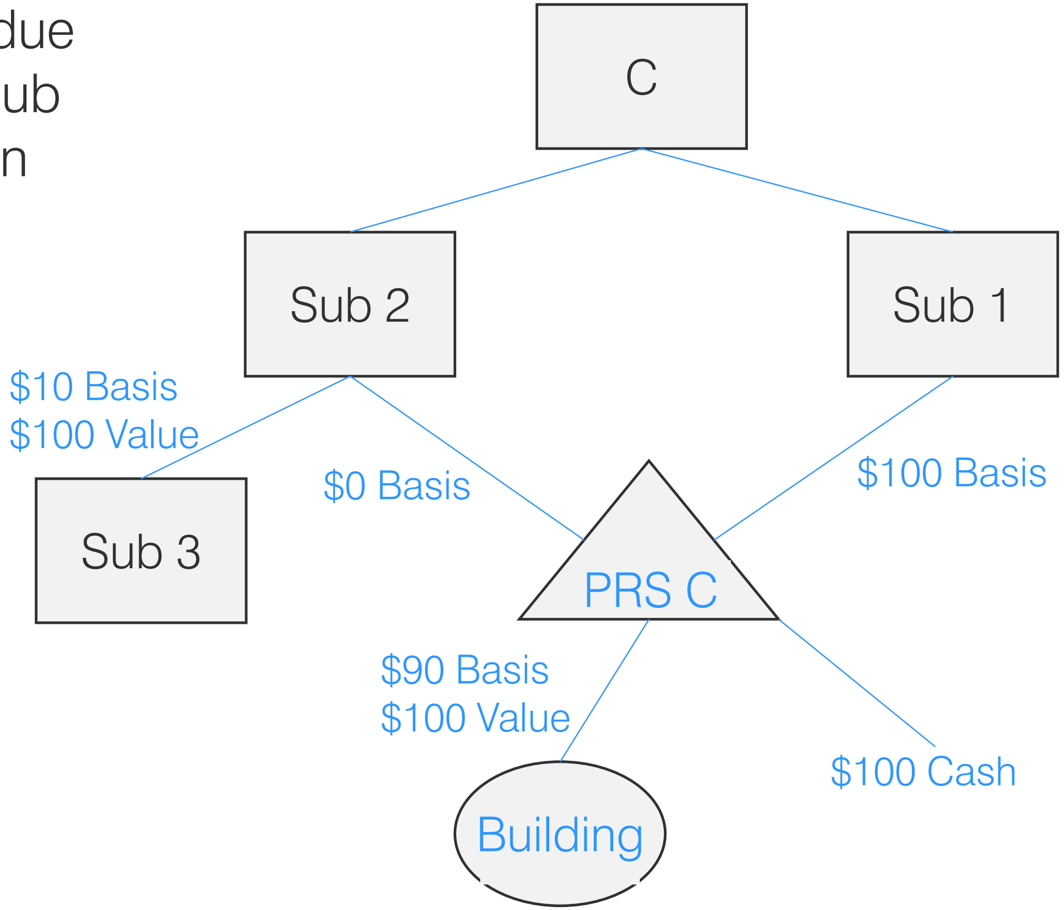
Rev. Rul. 2024-14 – Situation 2

- Partnership has a Section 754 election in effect.



Situation 2 (cont.)

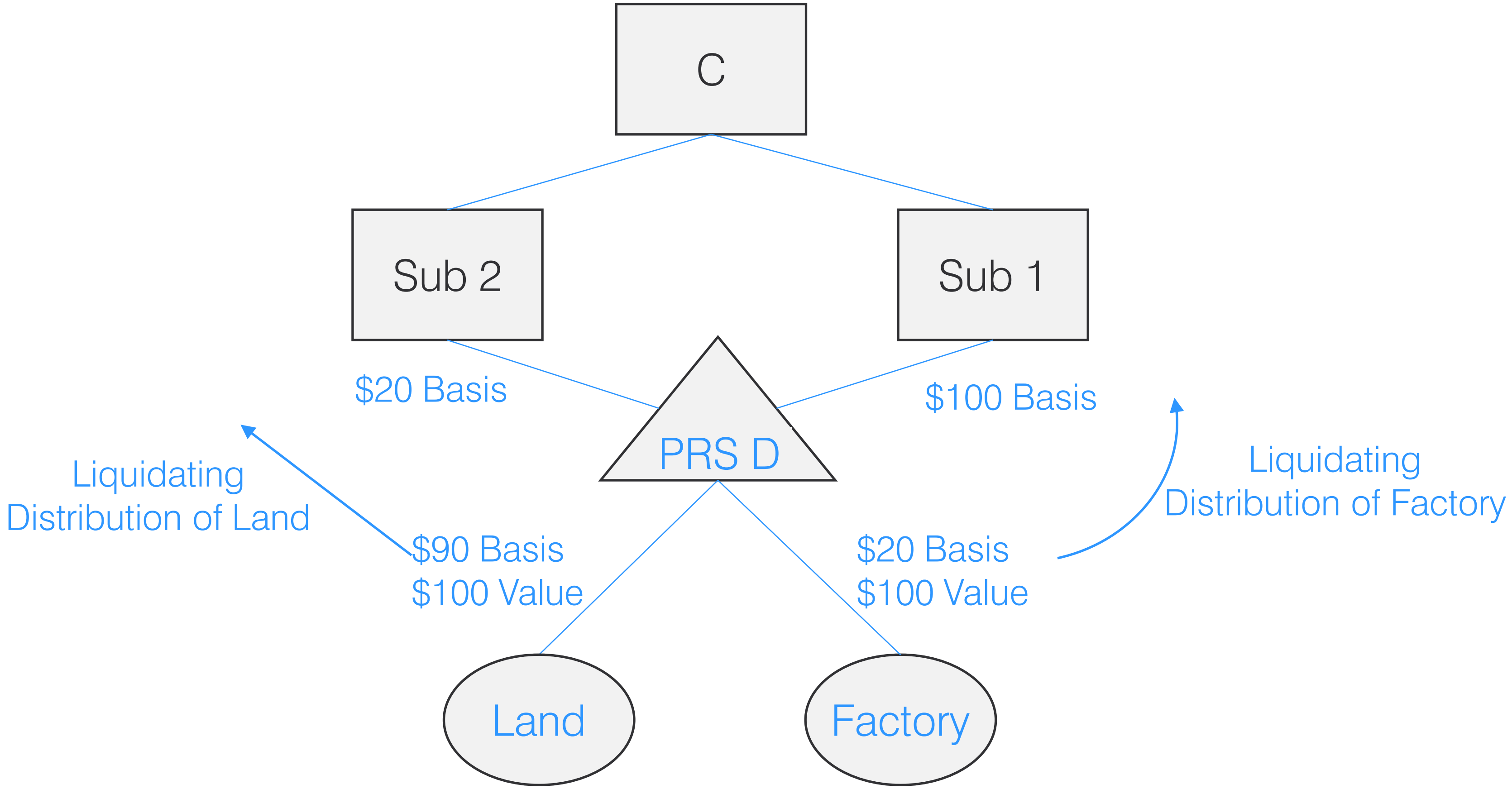
- Basis of Building is increased from $10 to $90 under Section 734(b) due to basis reduction in Sub 3’s stock under Section 732(a)(2).



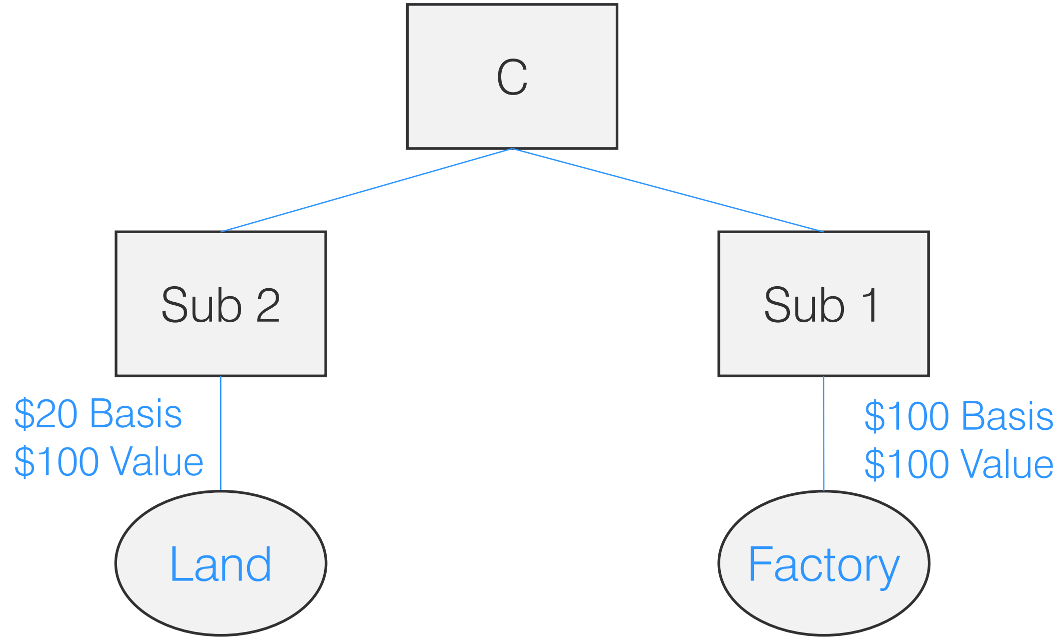
IRS Analysis

- The transaction lacks economic substance. It has a "negligible effect on *C*'s economic position" other than the tax savings from shifting basis from Sub 3 stock to the Building. The tax savings from additional basis dwarf any cost savings from realigning Sub 3 under Sub 2.
- As a result "the basis adjustment under Section 734(b) is disregarded." The inside basis of the Building remains $10.
- Section 7701(o) penalties would apply.
- IRS notes that Reg. 1.701-2 (subchapter K anti-abuse rule) may also apply.

Rev. Rul. 2024-14 – Situation 3



Rev. Rul. 2024-14 – Situation 3



- Under Section 732(b), each of Sub 1 and Sub 2 applies its outside basis to the property received in the liquidating distribution.

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Corner Post

Corner Post – Overview

- Corner Post, a truckstop and convenience store, opened in 2018.
- Corner Post was then injured by a federal agency’s preexisting debit-card regulation, which allowed intermediaries like Visa and Mastercard to charge 5%-plus-21-cents per transaction.
- The regulation was published in 2011. Corner Post facially challenged the regulation in 2021.

Corner Post Interpretation of APA

- The statute of limitations for APA claims says:

  "… every civil action commenced against the United States shall be barred unless the complaint is filed within ***six years after the right of action first accrues*** …"

- Most circuits thought the "right of action first accrues" when the regulation is published. If your new business started more than six years after the regulation was published, you could never bring an APA challenge to that regulation.
- The Supreme Court said "the right of action first accrues" when the plaintiff can bring the action—meaning once the plaintiff is *injured*—regardless of when the regulation was published. When your new business starts, you have six years after the regulation injures you. So Corner Post could challenge a 2011 regulation in 2021.
- "A right of action 'accrues' when the plaintiff has a 'complete and present cause of action'—*i.e.*, when she has the right to 'file suit and obtain relief.'"

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Loper Bright's Effect on Treasury Regulations

Loper Bright Enterprises v. Raimondo - Overview

- U.S. Supreme Court overruled *Chevron*, a 40-year-old precedent that set a high bar for challenging regulations in court
- Going forward, judges no longer have to (or can) defer to a regulation (or other agency interpretation of a statute) unless they're persuaded it's the best reading of the statute
- This should make it easier for taxpayers to succeed in challenging regulations
  - A lot will depend on the views of the judges, and less will depend on the views of the regulators
- The most vulnerable regulations will be those:
  - Where the statute did not include a specific grant of regulatory authority
  - Where the regulation governs a purely legal question
  - Where the regulation is not grounded in extensive fact-finding

The Old Rule: *Chevron* deference

- Before *Loper Bright*, courts followed a two-step test in determining whether to enforce regulations
- Step 1: Did Congress directly speak to the precise question at issue?
  - If the answer was yes, the court followed the clear will of Congress
  - If the statute was silent or ambiguous on the specific issue, the court moved to the second step
- Step 2: Was the regulation or other agency action a "permissible construction" of the statute even if it was not the reading the court would have reached in the absence of a regulation
  - Under Step 2, the court was not supposed to enforce its view of the best or correct answer
  - Instead, the court was supposed to defer to agency's presumed expertise as long as the regulation or agency action under review was reasonable
- Courts applied *Chevron* to tax regs since *Mayo Foundation for Medical Ed. & Research v. United States* in 2010
- Before that, they used a multi-factor test under *National Muffler Dealers Assn., Inc. v. United States*, a 1976 case

The New Rule under *Loper Bright*

- "Courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority"
  - Judges move front and center in deciding what that statutory authority is rather than providing the agencies power where statutes are ambiguous
- "Careful attention to the judgment of the Executive Branch may help inform that inquiry"
  - The use of the permissive "may" here is significant
- "[W]hen a particular statute delegates authority to an agency consistent with constitutional limits, courts must respect the delegation, while ensuring that the agency acts within it"
  - Determining what those constitutional limits are may be the next landmark case in administrative law
- "[A]gency interpretations of statutes—like agency interpretations of the Constitution—are not entitled to deference"
  - This represents a major break from past doctrine

Some Deference Remains Where There is Express Delegation

- The *Loper Bright* majority stated that courts should defer to an agency when Congress, acting within its constitutional powers, expressly delegated authority to the agency
  - When a statute "grants discretionary authority to an agency, the role of the reviewing court under the [Administrative Procedure Act] is, as always, to independently interpret the statute and effectuate the will of Congress subject to constitutional limits"
- Permissible delegations cited in the opinion include authority to
  - give meaning to a particular statutory term
  - promulgate rules to "fill up the details" of a statutory scheme
  - regulate subject to the limits imposed by a term or phrase that "leaves agencies with flexibility," such as "appropriate" or "reasonable"
- What about § 7805: ". . . the Secretary shall prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code?
  - Is the § 7805 delegation sufficient to create more deference for tax regulations?
  - Or will judges decide which rules and regulations are "needful"?

A few International Treasury Regulations worth considering

- Foreign tax credit regulations under Section 901
  - Statute allows credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country . . . ."
  - Delegations of regulatory authority are limited to specific subsections, but the regulations have taken controversial positions on the meaning of "income" taxes without any express delegation
- Branch currency regulations under Section 987
  - Statute mandates use of "profit and loss method"—contrary to proposed regulations
  - Partnership rules seemingly will have to hew to subchapter K
- Transfer pricing regulations under Section 482
  - Will the next court deciding a stock-based compensation case defer to Treasury's assertion that it can define by regulation what "arm's length" means, in the face of contrary evidence?
- Anti-inversion regulations under Section 7874
  - Are inversions no longer out of the question?

Tax Common Law

- Effect of *Chevron* repeal on tax "common law" doctrines, such as substance over form, step transaction, anti-conduit will need to be evaluated.
- IRS has been increasingly aggressive in arguing economic substance. This trend is likely to increase post-*Chevron*.
  - *Liberty Global v. United States* could be a precursor.
- Will courts have more incentive to create more tax "common law" doctrines?
- Will financial auditors have more incentive to create their own tax "common law" doctrines in evaluating whether a tax position meets the MLTN threshold?

Loper Bright Overturned Chevron but not cases applying it

- The Court did not call for a wholesale review of past rulings now that the ground rules have changed
- "[W]e do not call into question prior cases that relied on the *Chevron* framework. The holdings of those cases that specific agency actions are lawful—including the Clean Air Act holding of *Chevron* itself—are still subject to statutory stare decisis despite our change in interpretive methodology."
  - *Stare decisis* is the doctrine that a court generally should follow precedent
  - "Mere reliance on *Chevron* cannot constitute a 'special justification' for overruling … a holding, because to say a precedent relied on *Chevron* is, at best, 'just an argument that the precedent was wrongly decided.'"
- However, as *Loper Bright* itself shows, stare decisis is not an inexorable command. Factors weighed include
  - quality of the precedent's reasoning
  - workability of the rule it established
  - reliance on the decision

Varian: Regulatory Analysis post *Loper Bright*

- The Tax Court ruled for Varian, allowing Varian to claim a section 245A deduction for its section 78 gross up amount. *Varian Medical Systems, Inc. v. Commissioner*, 163 T.C. No. 4 (2024).
- Section 245A provides a DRD for U.S. corporations for the foreign-source portion of dividends they received from certain foreign corporations and applies to "distributions made after . . . December 31, 2017."
- TCJA amended section 78's gross up rules to provide that amounts treated as deemed dividends under section 78 do not qualify for the DRD under section 245A.
  - Amendment is effective for "taxable years of foreign corporations beginning after December 31, 2017, and . . . taxable years of United States shareholders in which or with which such taxable years of foreign corporations end."
- Varian, a fiscal year taxpayer, relied on this effective date mismatch to claim a deduction under section 245A in connection with the dividend it was treated as receiving under section 78 from its first tier CFCs.

Varian: Regulatory Analysis post *Loper Bright*

- The Tax Court's analysis was centered around the plain reading of the statutory text as applicable during the mismatch period.
  - Section 245A specifically provides that the DRD is allowed with respect to any dividend received by the US shareholder.
  - Section 78 provides that the gross up amounts must be treated as dividends received "for all purposes of this title" (i.e., the Code).
- The court ruled that the rule in Treas. Reg. section 1.78-1(c) that aligned the effective dates is contrary to the statute.
  - Looking to *Loper Bright*, the court found that the regulation cannot be followed as the plain text of the statute provides for the deduction.
  - The court stated that statutes, no matter how impenetrable, do—in fact, must—have a single, best meaning.
  - In cases involving ambiguity, "instead of declaring a particular party's reading 'permissible' . . . , courts [must] use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity."
  - The court ruled that the best, the unambiguous, reading of the section 78 provision here permits Varian's deduction.

Varian: Regulatory Analysis post *Loper Bright*

- The Tax Court ruled for the Commissioner by disallowing Varian's claim for an FTC relating to the section 78 gross up amount.
- Section 245A(d)(1) provides that "[n]o credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) <u>with respect to </u>any dividend for which a deduction is allowed under this section." (emphasis added).
- The court looks to the ordinary meaning of "with respect to."
- The court held that Varian's deemed paid foreign taxes undoubtedly relate to its section 78 dividend.

Other Cases & *Loper Bright*

- *Sysco v. Commissioner* (U.S. Tax Court, decided Sept. 13, 2024) –
  - Tax Court issued an order that followed the court's rulings in *Varian*, granting partial summary judgement for
    - Sysco Corp. to obtain a section 245A deduction for its 2018 section 78 dividend, and
    - The government by disallowing the related foreign tax credits.
  - After Varian was released, Sysco and the government agreed that it controlled and fully resolved all of their issues.
  - Brief arguments:
    - Text of section 245A(g)'s specific authority is broad – and authorizes IRS rulemaking, focusing on "necessary or appropriate" language.
    - Regulations fall within § 7805's general grant of authority.
    - Even absent delegation, IRS argues that § 245A regulations optimally resolved any ambiguity – and thus should hold as the correct interpretation of the statute.
    - IRS also argued that the regulations are entitled to *Skidmore* deference.
- *FedEx Corporation v. United States* (W.D. Tenn., pending)–
  - Specific grant of delegation under section 965 authorizes IRS action;
  - Section 965 regulations fell within IRS's express authority under both § 965 specific grant of authority and § 7805's general grant of authority.

Treaty Interpretation post-*Loper Bright*

- Post-*Loper Bright*, the Tax Court has still applied the standard in *Sumitomo Shoji Am., Inc. v. Avagliano*, 457 U.S. 176 (1982).
  - The *Sumitomo* standard provides that although not dispositive, an agency's interpretation of a treaty "is entitled to great weight." 457 U.S. at 184-85.
  - In the post-*Loper Bright* U.S. Tax Court case of *Ryckman v. Commissioner,* 163 T.C. No. 3 (2024), decided on August 1, the Tax Court still applied the "great weight" standard.
  - This highlights how other standards of deference relevant to tax law will still need to be reevaluated post-*Loper Bright*.

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Ryckman case

Ryckman

- The Tax Court ruled that a taxpayer has no right to a collection due process hearing from the IRS when the IRS is collecting a Canadian tax liability under the Canada-U.S. income tax treaty ("Treaty").
- The court held that the IRS is required under article 26 of the Treaty to collect an accepted Canada Revenue Agency claim as it would a U.S. tax assessment for which the taxpayer's right to a CDP hearing under sections 6320 and 6330 had lapsed or was exhausted.
- This case also raised a question of first impression on whether the Tax Court has jurisdiction to review an IRS denial of a hearing request regarding collection of taxes under a mutual collection assistance request made by Canada under the Treaty. The Tax Court determined that it does not because the IRS did not issue a determination letter to the taxpayer that would invoke its jurisdiction under section 6330(d)(1) and the IRS had no obligation to issue this letter.
    - Sections 6320(a) and 6330(a) require the IRS to notify a taxpayer of a lien filing or a proposed levy, respectively, and of the taxpayer's right to request (within 30 days of the notice) a CDP hearing with IRS appeals.

Ryckman

- The court held, in a 7-6 decision, that the treaty forecloses the administrative and judicial protections of the CDP statutes in the case of Canadian revenue claims.
- The court determined that even if the CDP statutes in principle apply to the IRS's collection of foreign taxes, Treaty article 26 requires the United States to treat a Canadian revenue claim as though the taxpayer has exhausted all its CDP rights. Therefore, when the IRS granted Canada's mutual collection assistance request and filed a lien against the taxpayer, the Treaty precluded what would effectively be an additional CDP hearing because such rights were exhausted or lapsed in Canada.
- Further, it was *Canada* that was required to notify the taxpayer of the lien, not the IRS.
- Because the taxpayer had no additional administrative or judicial rights in the United States under the CDP statutes with respect to the lien, neither statute imposed any obligations on the IRS in its treatment of the hearing request.
- Therefore, the IRS's denial letter foreclosing the taxpayer's CDP hearing request was not a determination letter subject to judicial review under section 6330(d)(1).

Ryckman

- This situation is analogous to one in which the IRS denies a CDP hearing request for a tax period and collection action for which the taxpayer already had a hearing opportunity. The Tax Court has held that it lacks jurisdiction to review a decision letter issued after an equivalent hearing on a nonstatutory request. Therefore, absent a determination made by the IRS under section 6320 or 6330, the taxpayer lacked the jurisdictional hook to enter the Tax Court.

Treaties and Other Related Developments

Tribunal Rules on India-U.S. Tax Treaty

- An Indian tribunal ruled on September 5 that a U.S. domestic LLC is eligible for a reduced tax rate under the India-U.S. income and capital tax treaty even though it is a disregarded entity for U.S. tax purposes.
- *General Motors Co. USA v. ACIT* is important, as it addresses whether U.S. disregarded entities can benefit from the India-U.S. tax treaty, even though the treaty does not explicitly cover them.
- The Indian tax authority argued that the LLC is a fiscally transparent entity that is itself not taxed in the United States and is therefore not eligible for treaty relief.
- The tribunal's analysis focused on whether the disregarded LLC had a U.S. owner subject to U.S. tax.
  - The ruling notes that the LLC received a Form 6166 residence certificate from the IRS stating that the LLC is a U.S. resident because its owner is a U.S. resident corporation subject to U.S. tax.
  - "As long as de facto entire income of the enterprise or the person is subjected to tax in that tax jurisdiction, whether directly or Indirectly, the taxability test [for application of the treaty] must be held to have been satisfied," the tribunal held.
- The Indian Revenue Service is likely to appeal this decision to the High Court.

U.S.-Australia Treaty Disagreement

- Draft Taxation Ruling TR 2024/D1 issued by the Australian Tax Office provides that payments made by Australian software distributors to U.S. software companies are royalties subject to Australian withholding tax. Two scenarios are covered:
  - An Irish subsidiary (IEL) of a U.S. parent grants the Australian distributor (OBA) the rights to market, promote, copy (for the limited purpose of permitting end-users to make copies for their internal use) and distribute the software and to sell licenses for the software to end-users. The end-users may obtain use of the software (i) by electronic download, (ii) as cloud content hosted on servers controlled by IEL, or (iii) as physical copies shipped by IEL. IEL retains all intellectual property rights, including the copyright, to the software.
  - The Australian distributor, AusCo, is granted a nonexclusive right to sell the software of its foreign parent, ForeignCo, in Australia. AusCo does not have any rights (including the copyright rights), title, or interest in the software. AusCo sells the following ForeignCo products: (i) computer software available for download from servers owned by ForeignCo and (ii) access to cloud-based software hosted on servers owned by ForeignCo.
- Treating these payments as royalties rather than business profits would “conflict with both the terms of the treaty as well as the Commentaries to the OECD Model Tax Convention,” wrote the US acting deputy assistant secretary to his Australian counterpart.

IRS Letter on Germany-U.S. Tax Treaty

- IRS Office of Associate Chief Counsel (International) released an information letter (INFO 2024-0011) dated April 11, 2024, addressing the 1989 Germany-U.S. income tax treaty article 25 (mutual agreement procedure) relief requirements
- The U.S. and German competent authorities must identify and resolve any interaction between articles 25 (MAP) and 29 (Refund of Withholding Tax).
  - The treaty permits the competent authorities to determine whether taxpayers in these circumstances are required to file a refund claim with the IRS or German tax authority before they are eligible to file a competent authority submission under article 25.
  - In addition, the letter states that if the refund claim were not timely filed, the competent authorities could determine that this failure could bar assistance from a competent authority.

Suspension of Russia-U.S. Tax Treaty

- Treasury announced that beginning August 14 it is suspending most of the provisions of its 1992 tax treaty with Russia, including the protocol.
- Treasury was responding to Russia's previous suspension of those same provisions in August 2023.
- The suspension covers paragraph 4 of article 1 and articles 5-21 and 23.
  - Article 1, paragraph 4 requires both countries to provide benefits covered under paragraph 2 of article 7 (Adjustments to Income in Cases Where Persons Participate, Directly or Indirectly, in the Management, Control or Capital of Other Persons); paragraph b of article 17 (Pensions); articles 22 (Relief From Double Taxation), 23 (Non-discrimination) and 24 (Mutual Agreement Procedure); and articles 16 (Government Service), 18 (Students, Trainees and Researchers), and 26 (Members of Diplomatic Missions and Consular Officers) for individuals who are neither citizens of that country nor, in the case of the United States, individuals having immigrant status there.
  - Articles 5-21 and 23 cover most of the treaty, and the remaining in-force provisions are limited, covering mutual agreement procedure and exchange of information.
- On April 5, 2022, the IRS paused the exchange of information under the Russia treaty; therefore, the Russia treaty does not currently have an exchange of information program.

India-U.S. Digital Services Tax Agreement

- On June 28 the United States and India announced that they had agreed to extend the November 24, 2021, compromise on the transition from India's existing equalization levy to the new multilateral solution under the OECD inclusive framework through June 30, 2024, or when the new solution is implemented.
- The United States also reached similar compromises with Austria, France, Italy, Spain, the United Kingdom, and Turkey earlier this year on existing digital services taxes in light of the revised timeline for adoption and signature of pillar 1.
- The political compromises require each of the foreign countries to allow taxpayers to credit all unilateral DSTs against pillar 1 when it is imposed, while the United States is required to terminate and not impose any trade actions against these countries.

Canada DST

- Canada’s Digital Services Tax Act went into effect on June 28.
  - Applies to companies that provide digital services, like online marketplaces, advertising, and social media platforms.
  - Unilateral 3 percent DST is retroactive to January 1, 2022.
  - The tax applies to companies with over €750 million ($813 million) in global annual revenues and C $20 million in Canadian revenue
- On June 10 numerous groups, including the National Foreign Trade Council, the U.S. Chamber of Commerce, and the U.S. Council for International Business, sent a letter to U.S. Trade Representative Katherine Tai urging the United States to act with respect to Canada’s enactment of a DST.
  - The groups urge the Office of the U.S. Trade Representative to initiate formal dispute settlement procedures with Canada, beginning with consultations under the U.S.-Mexico-Canada Agreement.

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Partnership International Issues

Rawat

- A foreign partner is not subject to U.S. tax on the portion of her gain from the pre-TCJA sale of a partnership interest that is attributable to U.S. source inventory gain, the D.C. Circuit held, reversing the Tax Court.
- Section 751 states that gain from the sale of a partnership interest "shall be considered as an amount realized from the sale or exchange of property other than a capital asset" to the extent that the gain is attributable to unrealized receivables of the partnership or inventory items of the partnership.
- The D.C. Circuit concluded that the language "shall be considered as an amount realized from the sale or exchange of property other than a capital asset" in section 751 effectively means "shall be considered as ordinary income."

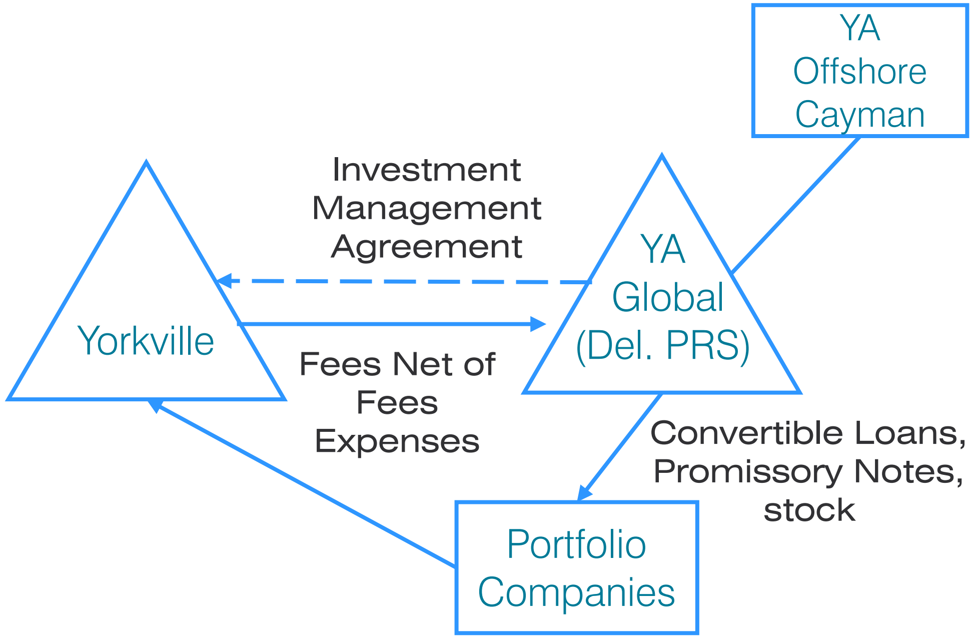
Rawat

- The court also compared section 751 with section 741, which provides that gain or loss from the sale of a partnership interest "shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751."
- What section 751 does <u>not</u> do, the court held, is change the character of the asset sold. The court noted that the statute does not require the gain to be considered income "from the sale of inventory" or "from the sale of such property."
- The court contrasted that choice with the language in section 751(b) providing that if a partner exchanges partnership property for unrealized receivables or substantially appreciated inventory, the transaction "shall . . . be considered as a sale or exchange of such property between the distributee and the partnership."

YA Global – Overview

- The partnership must withhold from any ECI that is allocable to the foreign partner, regardless of whether any distributions are paid to the foreign partner.
- Under Section 1446(a) and Treas. Reg. 1.1446-1(a) and -3(a)(2)(i), if a partnership has ECI that is allocable to a foreign partner under Section 704, then such partnership shall pay a 21% withholding tax on that ECI.
- If a partnership fails to pay and report Section 1446(a) withholding tax, Treas. Reg. 1.1446-3(e)(3) provides that the partnership becomes liable for the tax (unless it is paid in full by the foreign partner), estimated tax penalties, and interest.

YA Global – Illustration of Fact Pattern



YA Global – Issues and Holdings

- The Tax Court held that an agency relationship was created between Ya Global (a Cayman Islands partnership) and Yorkville Advisors (YA Global's general partner located in the US).
- As a result of this agency relationship, Yorkville's activities in the US were attributed to YA Global and this created US ECI for YA Global subject to withholding taxes under section 1446.
- YA Global was engaged in a lending and stock underwriting business, and all of its income was ECI
- The agreements governing the relationship identified Yorkville as an "agent" of YA Global and the court found that the taxpayer did not establish that the characterization was incorrect.
- YA Global could give interim instructions and retained control over Yorkville Advisors.
- Section 1446 withholding could not take into account YA Offshore non-partnership deductions, because not timely certified under section 1446 regulations
- The partnership was subject to failure to file / pay penalties and a tolled statute of limitations due to failure to file Form 8804 (report of Sec. 1446 withholding). Form 1065 was insufficient
- Reliance on advice from RSM and Schulte Roth did not establish reasonable cause to exempt YA Global from failure to file / pay penalties

YA Global – Relevant Takeaways

- Use of Restatement of Agency to impute activities to a foreign entity
  - Section 1.01 of the Third Restatement defines "agency" as "the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."
  - Court agreed with the IRS that It is "[t]he power to give interim instructions [that] distinguishes principals in agency relationships from those who contract to receive services provided by persons who are not agents."
- Issues and traps with Section 1446 withholding – consider implications for de facto partnership situations

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Transfer Pricing Developments

Transfer Pricing Cases

- *Coca-Cola*
- On August 2, 2024, the Tax Court issued its final decision in Coca-Cola finding almost $3 billon of tax deficiencies without interest for the three tax years at issue, 2007-2009.
- With interest, amounts could be as high as $6 billion, and up to $16 billion through 2023, could increase ETR by 3.5%.
- The amount relates to Cola-Cola's transfer pricing royalty from the foreign supply points for the use of intangible property, including trademarks and the secret formula, and the related Brazilian blocked income issue under section 482.
- Coca-Cola has 90 days to appeal to the Eleventh Circuit.
- Coca-Cola stated that it is evaluating the implications of *Loper Bright*.

Pending Transfer Pricing Cases

- *Airbnb*
- On July 30, Airbnb filed a petition in the Tax Court challenging the IRS's adjustment related to Airbnb's valuation of its intangible property in its platform contribution transaction (PCT) under the cost-sharing regulations for its 2013 tax year.
- The tax deficiency amount at issue is approximately $1.3 billion plus the 40 percent section 6662 penalty amount of about $500 million.
- Airbnb unwound its cost-sharing agreement with Ireland on August 31, 2020, before the initial public offering.
- The IRS valuation adjustment relies on a valuation from Airbnb's series D round of financing that closed three months after the PCT and in which investors acquired convertible preferred securities, not common stock.
- Airbnb used the income method to value the PCT IP.

Pending Transfer Pricing Cases

- *Amgen Inc. v. Commissioner*, T.C. No. 16017-21 (2021) and T.C. No. 15631-22 (2022)
- Amgen has two petitions in the Tax Court arguing that the IRS incorrectly increased the royalty payments for the license of IP from the US to its Puerto Rico manufacturing subsidiaries.
- The 2021 adjustment was over $3.6 billion for 2010-2012
- The 2022 adjustment was over $5 billion for 2013-2015
- Amgen argued the IRS failed to account for critical value drivers of the manufacturer including manufacturing expertise, manufacturing investments, and risks.

Pending Transfer Pricing Cases

- *Medtronic Inc. v. Commissioner*, T.C. Memo. 2022-84
- The issue is what is the best method to price the license of IP from the US to the Puerto Rico manufacturing subsidiary
  - Medtronic used the comparable uncontrolled transaction method (CUT)
  - IRS argued a comparable profits method (CPM) should be used
- The IRS lost in Tax Court in 2016, when the court agreed with the CUT method, with an upward comparability adjustment
- The Eighth Circuit remanded the case back to Tax Court to make the factual findings to support the CUT method
- The IRS lost again in Tax Court in 2022, and a second appeal is pending

Pending Transfer Pricing Cases

- *Eaton*
- The issue is the valuation related to Eaton's sale of intellectual property to its Irish affiliate.
- Eaton is in process of a summons fight related to performance evaluations of the Irish employees.
  - The U.S. District Court for the Northern District of Ohio denied Eaton’s motion for reconsideration on Eaton’s production of summonsed Irish employee performance evaluations to the IRS.
  - The Sixth Circuit partially overruled this decision and granted Eaton an administrative stay for 30 days while the court considers Eaton’s motion pending appeal.
- The ruling reinforces the breadth of the summons powers granted to the IRS under section 7602.
- The IRS said it needed the performance evaluations to assess the relative contributions of the foreign employees.
- Eaton argued that the IRS failed to establish its need for the evaluations and that releasing the evaluations to the IRS would violate EU law.
- The ruling stated that the IRS has a “minimal” burden when establishing its right to summons enforcement.

IRS Guidance

- In AM 2023-008 the IRS stated that it may consider related party group membership "implicit support" in determining the interest rate for intragroup loans even if there is no guarantee or other legally binding credit support.
- The legal advice memorandum rejected a hypothetical taxpayer argument that FP, in its role as creditor, would not benefit from the "implicit support" provided by itself, in its role as US Sub's parent, and thus should be entitled to a higher return to compensate for its greater risk.
- The IRS also states that the "implicit support" payment is a passive association benefit and that, absent a guarantee or other legally binding credit support payment, the borrower is entitled to retain the benefit it received from its group members without compensating any affiliate for that "implicit support."

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Recent IRS International Tax Guidance

F Reorg—LTR 202339009

- LTR 202339009 rules that publicly traded foreign corporation's redomiciling transaction qualifies as an F reorganization despite days of stock trading occurring before the final step in the transaction.
- The ruling shows that despite the seemingly mechanical requirements of Treas. Reg. 1.368-2(m), including the requirement that "the same person or persons must own all the stock of the transferor corporation determined immediately before the potential F reorganization, and of the resulting corporation, determined immediately after the potential F reorganization, in identical proportions,"
- Here the IRS showed flexibility when public trading renders exact identity of ownership impossible.

Source of Income—ECC 202346017

- In ECC 202346017 the IRS provided language to clarify where the production or the territory exceptions in section 863(b) apply to the general rule for sourcing income from the sale of inventory.
- Income derived from the sale of inventory property is generally sourced according to where title and risk of loss pass. However, income from the sale of inventory that is produced by the taxpayer is sourced according to an allocation between production and sales.
- In the advice, the IRS stated that to clarify when the general rule does not apply, a disclaimer similar to the following could be used: "However, the income from the sale of inventory purchased or produced by a seller within a U.S. territory and sold within the United States is sourced based on an allocation."

Notice 2024-16: Section 961 Basis (Overview)

- IRS plans to issue proposed regs on PTEP and § 961 basis issues for certain inbound transactions where there could be double taxation
  - A domestic corporation's acquisition of a CFC's stock in a § 332 liquidation or a § 368(a)(1) asset reorganization
- Taxpayers can rely on these rules for transactions completed on or before the date proposed regulations are published as long as the taxpayer and its related parties follow all of these rules in a consistent manner.

Background

- § 961 provides that, under regulations, the basis that a U.S. shareholder has in stock of a CFC is increased by the subpart F and GILTI inclusion under § 951(a).
- § 961(b) provides that, under regulations, stock basis is reduced by the amount that a U.S. shareholder receives that is excluded from gross income under § 959(a).
  - To the extent that an amount excluded from gross income under § 959(a) exceeds the basis of the stock with respect to which it is received, the amount is treated as gain from the sale or exchange of property.
- § 961(c) provides that, under regulations, if a U.S. shareholder is treated under § 958(a)(2) as owning stock in a CFC that is owned by another CFC, then adjustments similar to the adjustments provided by § 961(a) and (b) are made to the basis of the stock of those CFCs — but only to determine the amount included under § 951.
  - § 961(c) further provides that these adjustments do not apply with respect to any stock to which a basis adjustment applies under § 961(a) or (b).

Details of Notice

- Where a domestic corporation acquires a CFC from another CFC in a § 332 liquidation or a § 368(a)(1) asset reorganization (inbound nonrecognition transaction), the domestic corporation generally obtains a basis of the stock of the acquired CFC that is determined by reference to the basis of the stock in the hands of the transferor CFC (§§ 334(b)/ 362(b)).
  - Before the inbound nonrecognition transaction, the transferor CFC may have increased the acquired CFC stock basis under § 961(c), but the § 961(c) basis would apply only for determining the § 951 inclusion.
- A domestic acquiring corporation may recognize gain on a subsequent distribution of PTEP from the acquired CFC under § 961(b)(2) or recognize gain attributable to PTEP on a disposition of the acquired CFC if the adjusted basis in its stock does not reflect the § 961(c) basis that the transferor CFC had in its stock before the inbound nonrecognition transaction.
  - The notice provides that, in certain cases, this result may prevent taxpayers from engaging in these transactions and would be inconsistent with one of the purposes of § 961: preventing double taxation of the same CFC earnings.

Future Regulations

- Proposed regulations will provide that, in one of the covered inbound transactions, a domestic acquiring corporation's adjusted basis of the acquired CFC stock determined under § 334(b) or 362(b) is determined as if the transferor CFC's § 961(c) basis were adjusted basis.
  - However, § 961(c) basis is included here only if it resulted from gross income inclusions of the domestic corporation under § 951(a) or § 951A(a), or the § 961(c) basis was inherited by the domestic corporation under § 961(c)'s successor rules in an acquisition.
- Covered asset reorganizations are limited to:
  - § 368(a)(1)(A) reorganizations (but not § 368(a)(2)(D) or 368(a)(2)(E) reorganizations) ("nontriangular A reorganizations")
  - § 368(a)(1)(C) reorganizations (determined without regard to the parenthetical allowing triangular C reorganizations) (nontriangular C reorganizations), in which all of the stock of the transferor CFC is owned directly by the domestic acquiring corporation immediately before the transaction
  - § 368(a)(1)(D) and (F) reorganizations in which all of the transferor CFC and the domestic acquiring corporation are owned directly by a single domestic corporation (or by members of the same consolidated group)

Limitations

- Certain de minimis and limited special rules apply. Covered inbound transactions do not include reorganizations that:
  - involve boot equal to more than 1 percent of the total fair market value of the stock of the transferor CFC;
  - have built-in loss in the acquired CFC stock;
  - have subsequent transfers of the acquired CFC stock under § 368(a)(2)(C) or Treas. reg. § 1.368-2(k)(1), unless the transfer is within a consolidated group;
  - have subsequent transfers of the acquired CFC stock to a partnership or foreign corporation under a plan, which is deemed to exist if the transfer is within two years; or
  - involve an acquiring corporation that is a regulated investment company, real estate investment trust, or an S corporation.

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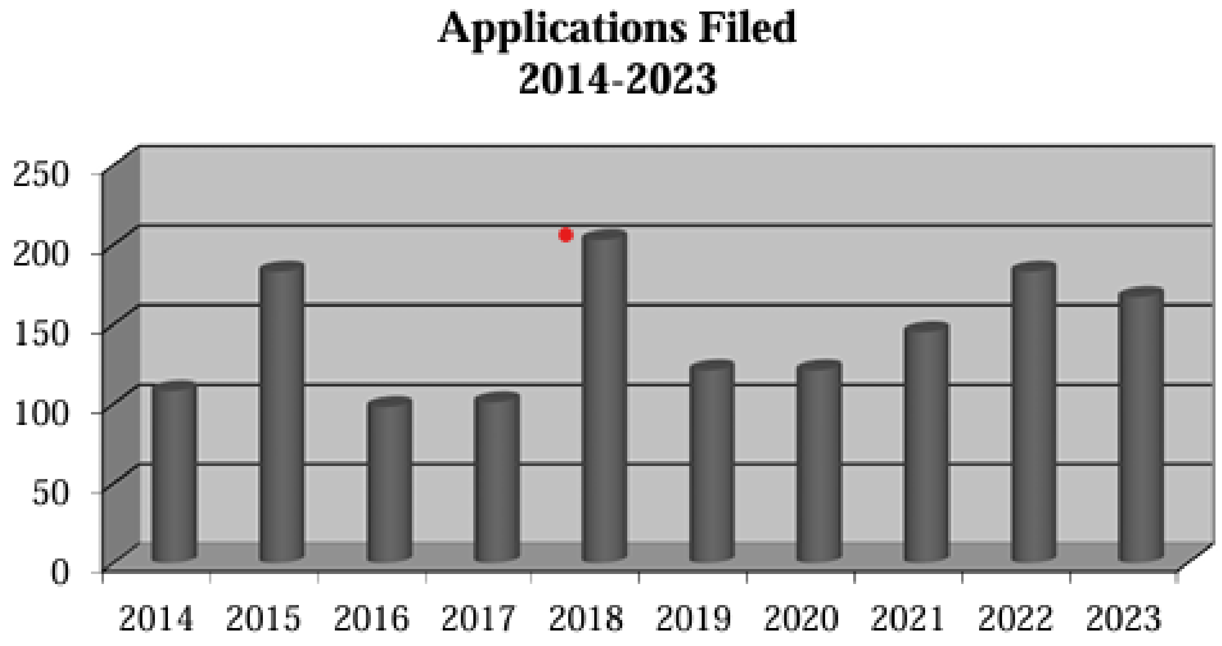
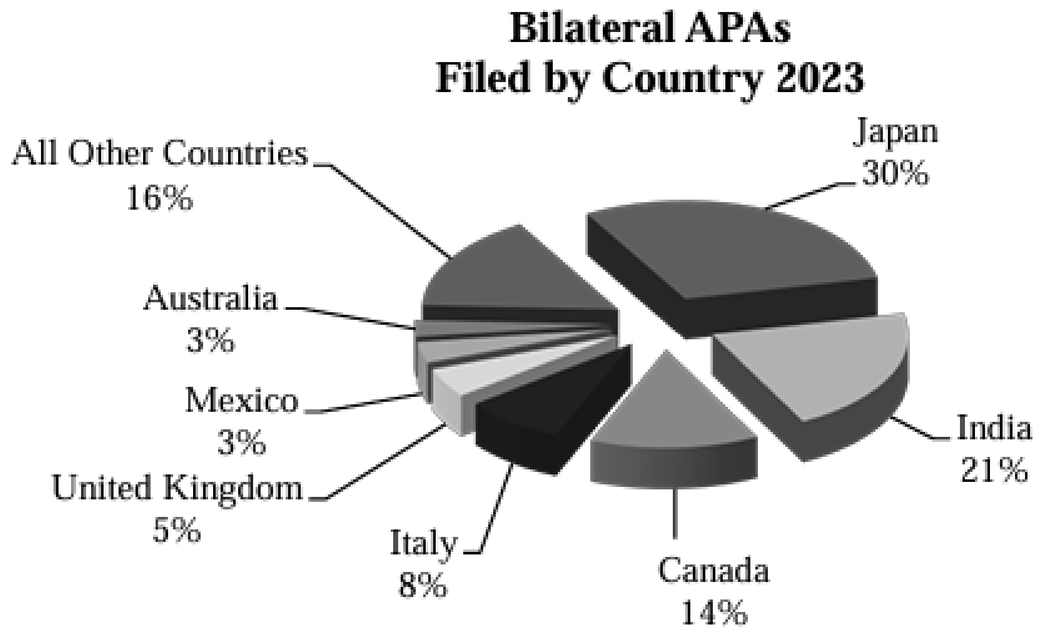
APA Report

APA Statistics – Filed APAs

- 167 APAs were filed in 2023 (17 unilateral, 144 bilateral, and 6 multilateral)

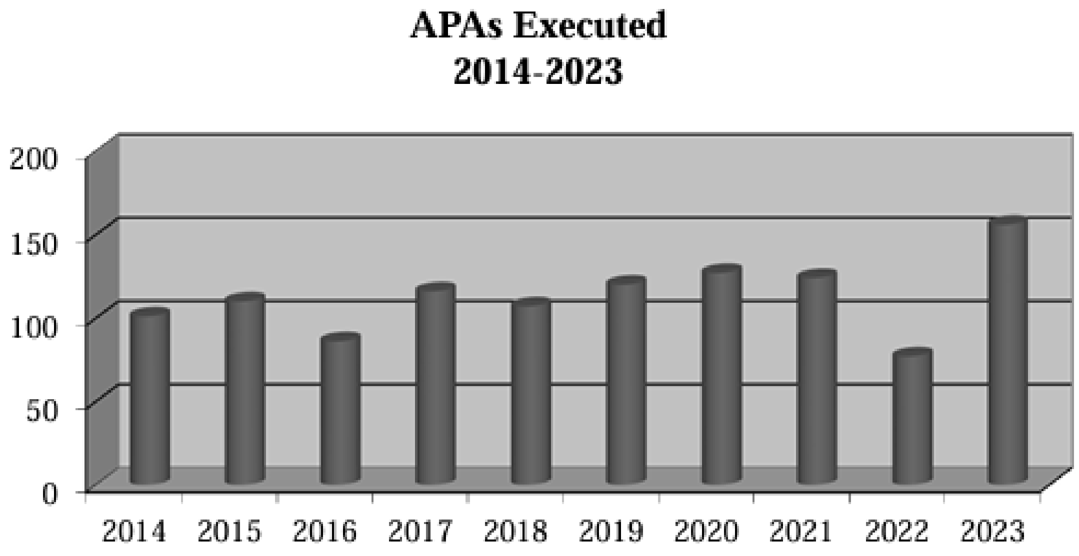


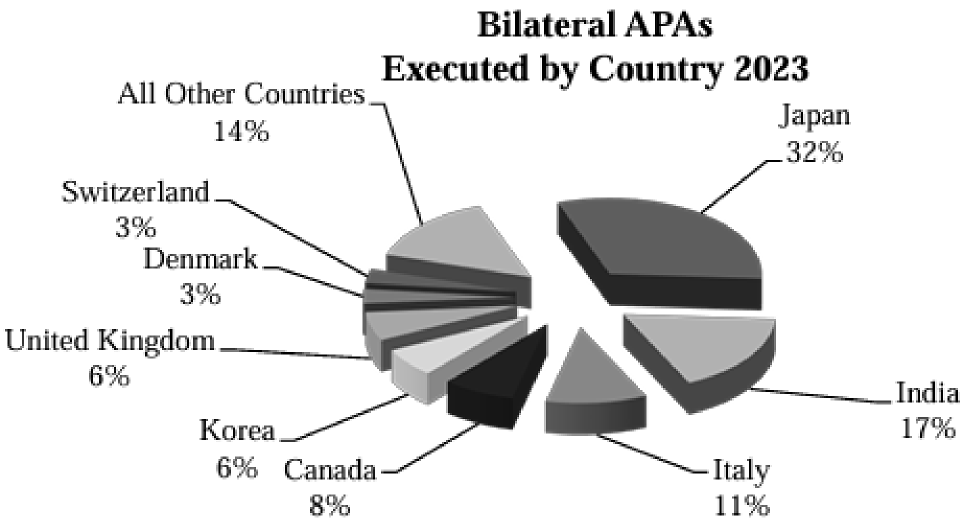


APA Statistics – Executed APAs

	Unilateral	Bilateral	Multilateral	Total
Total Executed 1991-2022	697	1,549	22	2,268
Total Executed in 2023	24	130	2	156
Total Executed 1991-2023	**721**	**1,679**	**24**	**2,424**
Total Pending as of 12/31/2023	**44**	**480**	**34**	**558**
Renewals Executed in 2023[5]	*15*	*59*	*0*	*74*
Renewals Pending[6] *as of 12/31/2023*	*33*	*199*	*20*	*252*

2023: 31% were in manufacturing, 30% in the wholesale/retail trade, 17% in the services industry, 12% in finance, insurance, and real estate, and 6% in management





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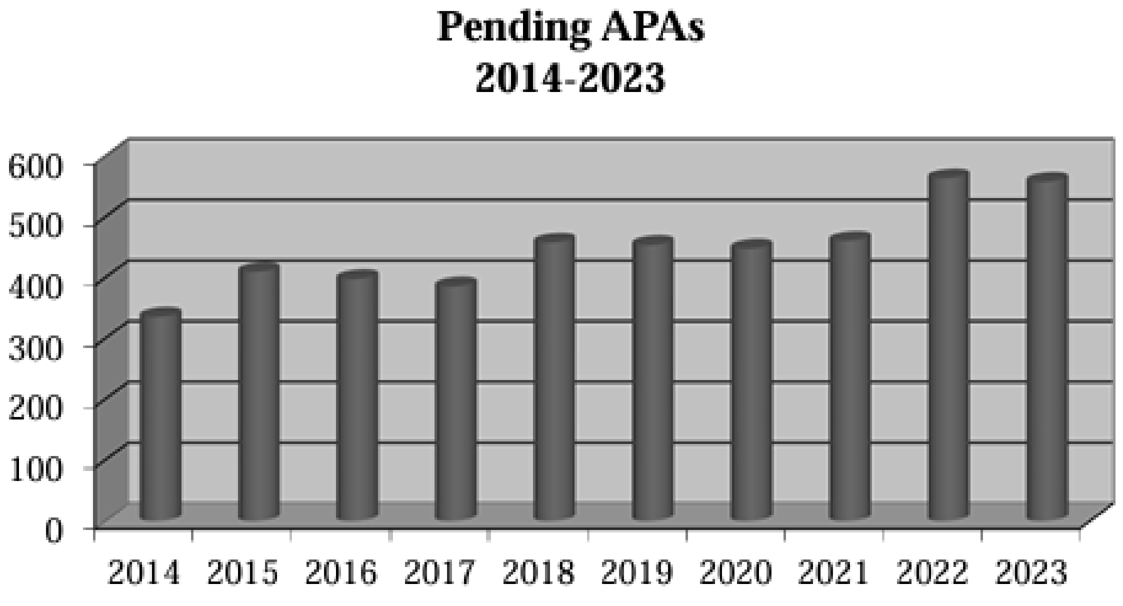
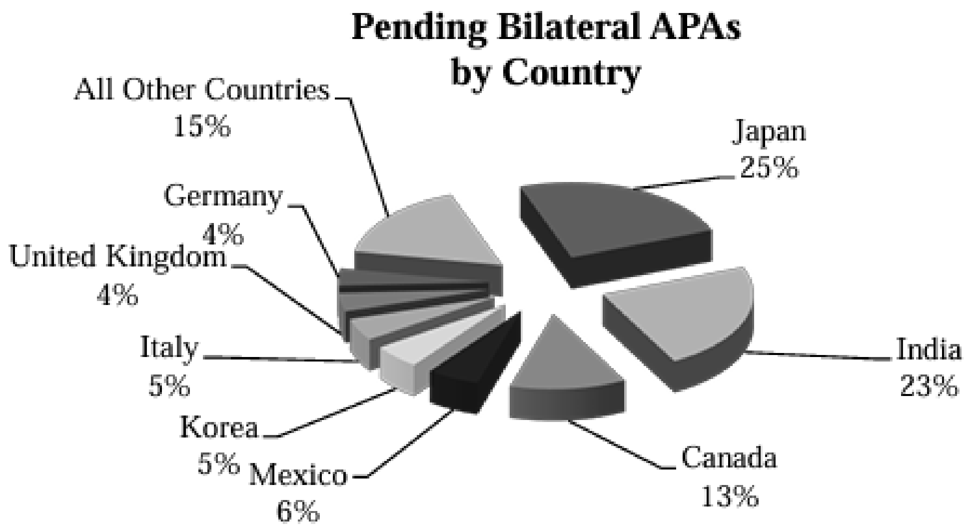
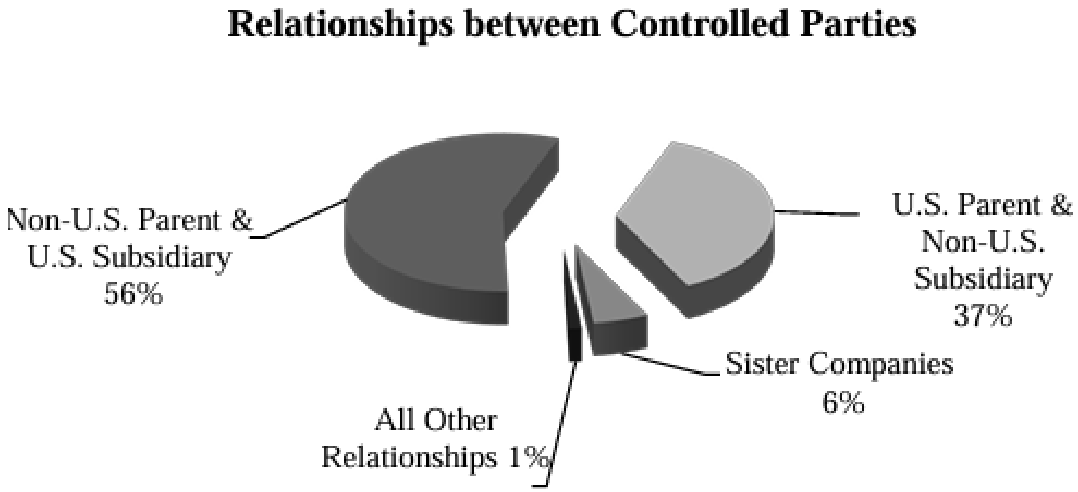
APA Statistics – Pending APAs

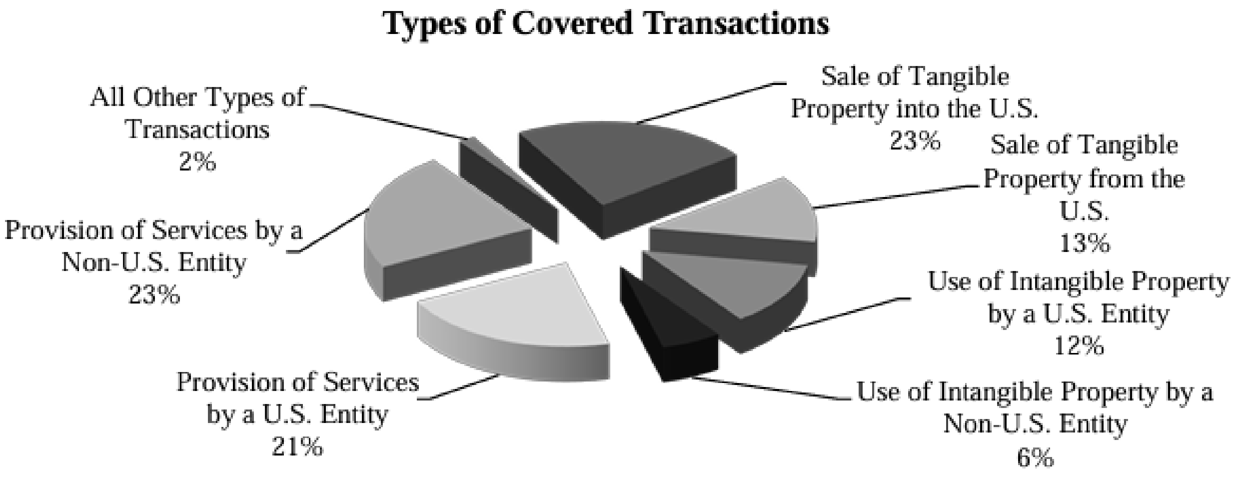




- No APAs were revoked or cancelled in 2023
- 13 APAs were withdrawn in 2023 (2 unilateral and 11 bilateral)

APA Statistics – Controlled Parties/Transactions





- Tested parties in 2023: US distributors (42%), US manufacturers (13%), US service providers (12%), non-US distributors (10%), and non-US service providers (22%).

APA Statistics – Term & Timing

- Term length in 2023: Average 6 yrs (70 APAs 5 yrs, 31 APAs 7 yrs, 20 APAs 6 yrs, 9 APAs 2 yrs, 6 APAs 8 yrs), with a minimum of 2 yrs and maximum of 14 yrs.
- Of the APAs executed in 2023, 19 percent included rollback years.
- Median completion time decreased in 2023 to 42.0 months (from 43.4 months in 2022).
- In 2023, it took an average of 45.2 months to complete a new unilateral APA and an average of 30.2 months to renew a unilateral APA.
- In 2023, it took an average of 50 months to complete a new bilateral APA and an average of 36.1 months to renew a bilateral APA.

APA Statistics – TP Methods

- Most commonly used TPM for sale of tangible property and the use of intangible property: comparable profits method/transactional net margin method (CPM/TNMM).
  - The CPM/TNMM was used for 80% of these transactions.
  - Operating margin (OM) is the most common profit level indicator (PLI) used to benchmark results, used 60% of the time.
  - Other PLIs (e.g., the Berry Ratio and return on total cost) made up the other 40%.
- Most services transactions (86%) also used the CPM/TNMM with the OM and operating profit to operating expense being the most common PLIs (used 48% of the time).

Questions?

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David focuses on international corporate taxation. David has been named 2021 Tax Leaders by the *International Tax Review*'s Tax Leaders Expert Guide. He is included in *Euromoney's* Tax Advisors Expert Guides (World's Leading Tax Advisors, World's Leading Transfer Pricing Advisors and was named one of the Top 30 U.S. Tax Advisors). He is also in *The Legal 500 Hall of Fame* and is regularly recognized in the *Law and Business Research's* International Who's Who of Corporate and Tax Lawyers. David is listed in *Chambers USA* America's Leading Lawyers for Business, and has been named a Northern California Super Lawyer in Tax by *San Francisco Magazine*.

David is a lecturer at Stanford Law School and UC Berkeley Law School where he focuses on international taxation. He is an editor of and regular contributor to the *Journal of Taxation*, where his publications have included articles on international joint ventures, international tax aspects of mergers and acquisitions, the dual consolidated loss regulations, and foreign currency issues. He is a regular contributor to the *Journal of Passthrough Entities*, where he writes a column on international issues. David is a frequent chair and speaker at tax conferences, including the NYU Tax Institute, the Tax Executives Institute, and the International Fiscal Association.

David graduated with an A.B., *cum laude* and Phi Beta Kappa, from Princeton University's Woodrow Wilson School of Public and International Affairs, and received his J.D., with distinction, from Stanford Law School.

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Julia advises on U.S. tax planning and tax controversy matters, with an emphasis on international tax (inbound and outbound). She represents clients from a diverse set of industries and geographic areas. She has represented a number of Fortune 500 companies in U.S. federal income tax matters and has successfully represented clients in federal tax controversies at all levels.

Chambers USA recognizes Julia as a leading tax practitioner, with clients stating that she "is extremely knowledgeable and thoughtful in her support" and "comes well prepared." She was also named as Tax Dispute Resolution Lawyer of the Year in 2021 and was shortlisted in the Tax Lawyer of the Year category in 2022 and 2020 by International Tax Review at the Americas Women in Business Law Awards. Julia was honored as one of the top 40 lawyers under 40 in the U.S. by the American Bar Association in 2018 and is regularly recognized in Euromoney's Expert Guides and on International Tax Review's Women in Tax Leaders list.

In addition, Julia teaches international tax at UC Berkeley School of Law and in the Master's Program at San José State University. Julia is an author of a monthly column in Tax Notes on international tax developments and regularly speaks at major tax conferences for professional tax groups, including for the Tax Executives Institute (TEI), the International Fiscal Association (IFA), International Tax Review (ITR), and Pacific Rim Tax Institute. Julia is also the co-President of the Northern California region for the International Fiscal Association.

Representative Experience

- Julia was counsel in successfully settled Conversant et al. v. Commissioner, Tax Court Docket No. 030476-14, and was on the trial team that was successful in Analog Devices & Subsidiaries v. Commissioner, 147 T.C. No. 15 (Nov. 22, 2016).
- Advised publicly traded and private multinationals on restructurings and location of intellectual property to optimize their U.S. tax positions, including with respect to subpart F, GILTI, FDII, foreign tax credits, and BEAT.
- Advised Meta (fka Facebook) as special tax counsel in its $5.7B investment for a 9.99% stake in Jio Platforms, the biggest telecom operator in India and a subsidiary of multinational conglomerate Reliance Industries.
- Advised GitHub in its $7.5B acquisition by Microsoft.
- Advised Goldman Sachs and 13 major New York banks in their investment in Symphony Communications, which won International Tax Review's Joint Venture of the Year award.

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