FENWICK

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International High Technology U.S. Tax Current Developments

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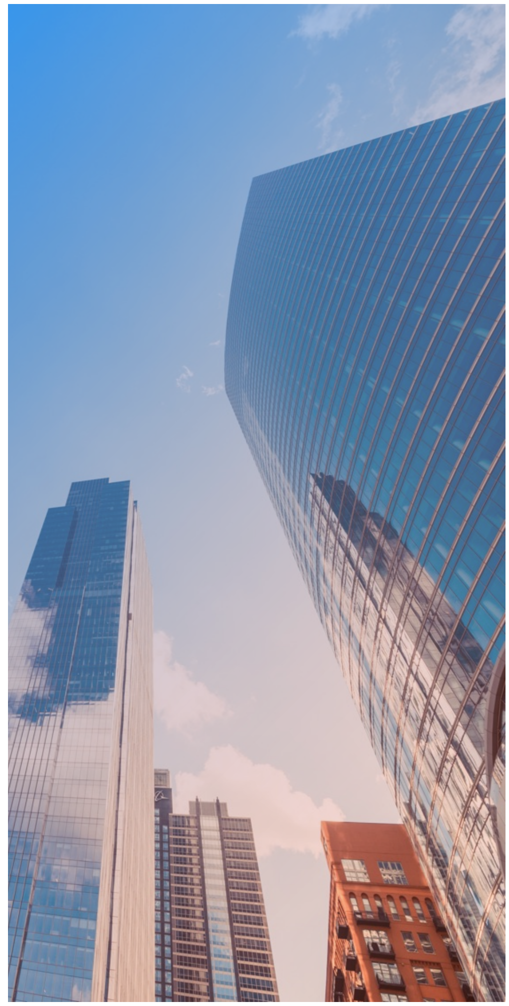


Agenda

- Recent Caselaw Developments
  - *Moore*
  - Economic Substance
  - APA Cases
  - And more
- Foreign Tax Credits
- Transfer Pricing Developments
- Sec. 367(d) developments
- IRS Guidance

Recent Caselaw Developments

Moore

- In *Moore*, the U.S. Supreme Court will consider whether the 16th Amendment authorizes Congress to tax unrealized sums without apportionment among the states.
- The case concerns the constitutionality of section 965, and the taxpayers are individuals who were subject to taxation under section 965 for their minority stake in a CFC that has never distributed its profits or otherwise made a dividend payment. Oral argument is expected later this year.
- In amicus brief the Cato Institute argues that income has always included a realization requirement, that this requirement is fundamental to the definition of income (as the term is used in the 16th Amendment), and that section 965 does not tax income.
- An amicus brief filed by 16 states (led by West Virginia), argues that the Court should not redefine income to include unrealized sums. The states are concerned that if section 965 is held to be constitutional, then "the federal government will be empowered to overrun traditional state authority over property and other ad valorem taxes while dangerously weakening state economies and fiscs."

Economic Substance

- 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.
- The past 18 months have seen a striking increase in the IRS's assertion of the economic substance doctrine, and the 40% strict liability penalty.

Economic Substance Transactions

- According to LB&I-4-0422-0014, the following facts and circumstances tend to show that application of the economic substance doctrine may be appropriate:
  - Transaction is highly structured.
  - Transaction includes unnecessary steps.
  - Transaction is not at arm's length with unrelated third parties.
  - Transaction creates no meaningful economic change on a present value basis (pre-tax).
  - Taxpayer's potential for gain or loss is artificially limited.
  - Transaction accelerates a loss or duplicates a deduction.
  - Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset).

Economic Substance Transactions (cont.)

- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction.
- Transaction involves a tax-indifferent counterparty that recognizes substantial income.
- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years.
- Transaction has no credible business purpose apart from federal tax benefits.
- Transaction has no meaningful potential for profit apart from tax benefits.
- Transaction has no significant risk of loss.
- Tax benefit is artificially generated by the transaction.
- Transaction is pre-packaged.
- Transaction is outside the taxpayer's ordinary business operation.

Liberty Global

- Liberty Global is challenging the DOJ's disregard of an entity conversion under the economic substance and step transaction doctrines. Liberty Global claimed a § 245A DRD on a distribution of E&P generated upon the conversion.
    - 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.
- DOJ asserts that Liberty Global undertook a "series of highly engineered related-party transactions" to avoid tax.
- Liberty Global asserts that the economic substance doctrine is not relevant to the entity conversion. It analogizes the conversion to entity classification elections which are authorized by Treasury Regulations even though they have only tax effects.

Sec. 958(b)(4) Downward Attribution Case - *Altria*

- Altria owned slightly more than 10 percent by vote and value of Anheuser-Busch InBev SA/NV (ABI), a Belgian publicly traded multinational brewing and beverage company, and, thus, was a U.S. shareholder under § 951.
  - ABI was not a CFC before repeal of § 958(b)(4)
  - ABI owned foreign subsidiaries and wholly and directly owned a domestic subsidiary - after TCJA's repeal of § 958(b)(4), downward attribution resulted in ABI foreign subsidiaries being treated as CFCs and Altria being required to include subpart F income of those foreign subsidiaries.
- Altria argues that it lacked the requisite control to cause ABI's foreign subsidiaries to pay dividends and that, consequently, the taxation of ABI's foreign subsidiaries' subpart F income is unconstitutional.

APA Cases

- *Green Valley:* Tax Court holds that IRS notices are subject to the Administrative Procedure Act.
  - Notice 2017-10, 2017-4 IRB 544, regarding charitable deductions related to syndicated conservation easements as listed transactions, was at issue.
  - Like the Sixth Circuit in *Mann Construction*, the court here found the notice at issue to be a legislative rule, because the act of identifying a transaction as a listed transaction by the IRS, by its very nature, is the creation of a substantive (legislative) rule and not merely an interpretative rule.
  - Having determined that Notice 2017-10 is a legislative rule, the court stated that the IRS must go through notice and comment rulemaking under the APA. Although the APA also provides that an agency may depart from normal notice and comment procedures for good cause, the IRS here elected not to invoke the good-cause exception when issuing Notice 2017-10.
- *Govig* and *Oom*: District courts (D. Ariz and D. NJ) hold that the Sixth Circuit's decision in *Mann Construction* does not have nationwide scope.

Microsoft FOIA Case

- In *Microsoft* the Western District of Washington held that the IRS was not required under the Freedom of Information Act to search for and provide records of outside law firms that the IRS used during its audit.
- Under FOIA, persons have a right to secure government information to ensure an informed citizenry, to check against corruption, and to hold the government accountable. Federal agencies have a duty to construe FOIA requests liberally and must demonstrate a search reasonably calculated to uncover all relevant documents.
- The court held that the IRS was not required to search records outside its possession. Those records are not "agency records" for purposes of the FOIA, according to the court.
- As to Microsoft's argument that the records were not privileged, the court found that the attorney contractors were hired in part for legal analysis and that a rebuttable presumption of privilege applies.

Farhy Case

- Tax Court holds that the IRS could not assess penalties under section 6038(b) against a taxpayer who failed to file Form 5471, and that it could not collect these penalties via a levy.
- Section 6671(a) provides that the penalties found in chapter 68 (B) of subtitle F (that is, in sections 6671-6725) "shall be assessed and collected in the same manner as taxes." This provision does not include section 6038.
- The court found that other code sections that trigger penalties commonly:
  - contain their own express provision specifying the treatment of penalties or other amounts as a tax or an assessable penalty for purposes of assessment and collection;
  - contain a cross-reference to a provision within chapter 68 of subtitle F providing a penalty for their violation; or
  - are expressly covered by a penalty provision within chapter 68 of subtitle F.

Sec 78 Reg Cases

- *Kyocera*: the taxpayer challenged the validity of a regulation purporting to deny domestic corporations a deduction for section 78 dividends deemed received from their fiscal-year foreign subsidiaries between January 1, 2018, and the end of the subsidiaries' first tax year ending after December 31, 2017.
- The amendment to section 78 was applicable "to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end." Thus, under the statute's plain language shareholders of fiscal-year foreign corporations were able to deduct deemed dividends of creditable tax. Treas. Reg. 1.78-1 purported to change the effective date so that the denial of a deduction applied to "section 78 dividends that are received after December 31, 2017, by reason of taxes deemed paid under section 960(a) with respect to a taxable year of a foreign corporation beginning before January 1, 2018."
- Kyocera's complaint alleges that the regulation is invalid because it "contradicts the clear and unequivocal statutory effective date."
- Kyocera has received a refund, which, according to the government's April 25 filing, renders the case moot.
- The government has mooted other cases by offering a refund. The Sixth Circuit has held that a taxpayer cannot continue to litigate a case where the government has offered a refund. *See Jarrett v. United States*.
- Varian and Sysco are making similar challenges on the section 78 regulation.

Rawat Partnership Case

- The Tax Court held that a foreign partner is subject to U.S. tax on the portion of her gain from the sale of a partnership interest that is attributable to U.S.-source inventory income.
- The taxpayer made an argument similar to the taxpayer in *Grecian Magnecite*, stating that per section 741 her partnership interest was a singular "capital asset" and that it is not permissible to look through the partnership.
- The Tax Court, however, held that the general entity-level approach of section 741 gives way to the specific provision in section 751(a)(2) that the portion of the sold partnership interest attributable to inventory items must be separately "considered" as pertaining to "other than a capital asset."

IRS summons power cases

- *Poselli*: Third parties cannot prevent the IRS from gaining access to their bank account information if the IRS seeks that information to collect a delinquency from another taxpayer.
- The Service sought to collect $2 million from the taxpayer and issued summonses for the bank records of the taxpayer, his wife, and other third parties. The IRS issued the summonses to the banks but did not notify the account holders. When the banks told the account holders, a few of them moved to quash the summonses.
- The Supreme Court held that because no notice was required, the account holders could not bring a motion to quash.
  - "A straightforward reading of the statutory text supplies a ready answer [to whether the legal interest test applies]: The notice exception does not contain such a limitation," Chief Justice Roberts wrote for the Court.
  - At oral argument, the government proposed that as long as a summons is "reasonably calculated to assisting in collection," it can fairly be characterized as being issued "in aid of" that collection. The Court did not tackle that question.
  - Justice Ketanji Brown Jackson wrote a concurring opinion, in which Justice Neil Gorsuch joined, arguing that "courts must not interpret section 7609(c)(2)(D)(i) as if [the IRS] has been gifted with boundless authority" to issue summonses without notice.

IRS summons power cases

- *Rabassa*: A district court upheld an IRS summons for bank records on behalf of Spain under the Spain-U.S. income tax treaty.
  - The taxpayer argued that because he was not a resident of Spain or the United States, and because his reading of the Spain-U.S. treaty indicated that its scope is limited to residents of Spain or the United States, he was not subject to the treaty and the summons was plainly improper.
  - The court stated that section 7602, which gives the IRS authority to issue a summons, extends to requests made to the IRS by treaty partners. In summons enforcement proceedings, courts may ask only whether the IRS issued a summons in good faith and must eschew any broader role of overseeing the IRS's determinations to investigate.
  - The court reverted to the *Powell* test, under which government can make a prima facie showing of good faith through the following factors:
    - that the investigation will be conducted pursuant to a legitimate purpose;
    - that the inquiry will be relevant to that purpose;
    - that the information sought is not already in IRS possession; and
    - that it has taken the administrative steps necessary to the issuance of a summons.

IRS summons power cases

- *Kraken*: Court limits scope of IRS summons authority:
  - Summons sought information about activities of various users of the Kraken platform, including the user's identity (name, date of birth, taxpayer identification number, physical address, telephone number, and email address), use and access of the platform (including, among other things, payment cards, IP addresses, and other similar information), and information about the transactions in which they engaged (including the full transaction history and cryptographic records and ledgers relating to the transactions).
  - Kraken alleged the summons was overbroad and would impose too heavy a compliance burden. Kraken argued that the summons was significantly broader than the summons that the IRS issued to Coinbase, which was limited by a judge.
  - Applying the Powell factors (specifically, whether the Kraken summons served a legitimate purpose and sought relevant information), the district court limited the summons to identifying information and certain transaction history. The court found that certain information requested by the government, including an individual user's employment, net worth, and source of wealth, as well as anti-money-laundering logs and records, was outside the proper scope of a summons at this stage in the IRS investigation.
  - The court stated that to move beyond speculation, the IRS must first address whether there is anything in the user's transaction history that makes it reasonable to conclude that the information it seeks in these requests will actually yield information relevant to that user's tax compliance.

Foreign Tax Credits

Sec. 901 FTC Regulations: Notice 2023-55

- Taxpayers can choose to apply the previous final version of Treas. Reg. Sec. 1.901-2(a) (definition of income tax, including the predominant character rule) and (b) (net gain requirements)
  - New Sec. 1.901-2 rules that remain in place are in (d) (separate levies), (e) (compulsory payment rules), (f) technical taxpayer, and (g) (certain definitions)
- Digital Services Taxes (DSTs)
  - Former Treas. Reg. Sec. 1.901-2(b)(4)(i) is altered so that gross basis tax imposed on gross receipts or gross income from DSTs doesn’t satisfy the net income requirement

Sec. 903 FTC Regulations: Notice 2023-55

- Taxpayers must apply current final Tres. Reg. Sec. 1.903-1 without applying
  - § 1.903-1(c)(2)(iii) the requirement for source-based attribution; and
  - § 1.903-1(c)(1)(iv) the requirement that the tested tax be in lieu of a net income tax that meets the attribution requirement
- Digital Services Taxes

Notice 2023-55 Applicable Years

- Taxpayers may choose to apply the Notice to foreign taxes paid in tax years beginning on or after Dec. 28, 2021 and ending on or before December 31, 2023
- Consistency Requirement
  - Taxpayers choosing to apply the temporary relief must apply it to **all** foreign taxes paid, including taxes paid by CFCs, during the relief years (2022 and 2023, generally).
- How do you plan for 2024?

FedEx

- Refund case in the Western District of Tennessee (Memphis).
- District Court held that Treas. Reg. § 1.965-5(c) is invalid under *Chevron* Step 1, and FedEx is entitled to its refund on account of foreign tax credits upon repatriation of Section 965(b) PTEP.
- Case turned on statutory interpretation of two provisions:
  - Section 960(a)(3) (2017): "Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year."

FedEx

- Section 965(b)(4): "For purposes of applying section 959 . . . [the United States shareholder's reduction in Section 965(a) Subpart F income under Section 965(b)] shall be treated as an amount which was included in the gross income of such United States shareholder under section 951(a)."

- No taxes had ever been deemed paid on FedEx's Section 965(b) earnings. The government argued that the taxes must have been deemed to have been deemed paid under Treas. Reg. § 1.965-5(c), because the earnings were deemed to have been included in income under Section 965(b)(4).

- The Court disagreed and held for the taxpayer.

- See also *Sysco Corp. v. Commissioner* - Tax Court petition filed Apr. 18, 2023

FedEx

- Considerations for taxpayers contemplating refund claims:
  - *FedEx* arose under old Section 960(a)(3), applicable to CFC tax years beginning on or before Dec. 31, 2017
  - For CFC tax years beginning after Dec. 31, 2017, Section 960(b) is similar but not identical – foreign taxes must be "properly attributable" to the PTEP distribution and not previously deemed paid; also provides an explicit rule for tiered CFC PTEP distributions
  - Statute of limitations considerations, application of 10-year refund SOL under Section 6511(d)(3)

Polk

- Section 6511(d)(3) statute of limitations dispute in the Court of Federal Claims, decided Aug. 21, 2023
- Taxpayers filed refund claim for $196,000. Of that amount, $37k was based on a foreign tax credit, and the remaining $159k was based on other issues.
- The government moved to dismiss the $159k portion of the claim on the ground it was statute-barred.
- The court held for the government in a lengthy opinion.

Transfer Pricing Developments

3M Case Overview

- Sharply divided Tax Court held that the IRS has the authority to reallocate foreign income under section 482 when that income is blocked under foreign law.
- Reviewed by the court panel of 17 Tax Court judges, 8 dissenters.
- 3M challenged the validity of Treas. Reg. 1.482-1(h)(2) addressing when foreign legal restrictions are considered for transfer pricing purposes.
- 3M argued that the section 482 transfer pricing adjustment was improper because an additional royalty payment would have violated Brazilian law.
- The IRS asserted that 3M Brazil should have paid royalties of 6% and made an adjustment of over $23 million for the 2006 taxable year.
- Tax Court held the regulation was valid and that the IRS could reallocate the income.

3M Case Facts

- 3M Brazil was engaged in manufacturing and distribution of 3M products.
- The 3M global transfer pricing policy was a standard licensing agreement with a royalty of 6% of net sales.
- Under Brazil law the Brazilian Patent and Trademark Office (BPTO) prevented 3M Brazil from paying royalty payments for patents and other technology.
- As a result, 3M Brazil could not pay a 6% royalty.

3M Case Legal Background

- This is not a new issue.
- Multiple courts including the Supreme Court have concluded that the IRS does not have the authority to reallocate income when foreign law prevents that income from being paid, this is called blocked income.
- Faced with a string of losses, Treasury promulgated regulations purporting to authorize the allocation, and thus taxation, of blocked income in the 482 regulation.

Relevant Regulations

- Treas. Reg. § 1.482-1(h)(2) (2006) provides that a foreign legal restriction is taken into account in making allocations under section 482 if seven requirements are met:
  - (1) the restriction affected uncontrolled taxpayers under comparable circumstances for a comparable period of time,
  - (2) the restriction was publicly promulgated,
  - (3) the restriction was generally applicable to all similarly situated persons (both controlled and uncontrolled),
  - (4) the restriction was not imposed as part of a commercial transaction between the taxpayer and the foreign government,
  - (5) the taxpayer exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of the restriction (other than remedies that would have a negligible prospect of success),
  - (6) the restriction expressly prevented the payment or receipt, in any form, of all or part of the arm's-length amount, and
  - (7) the taxpayer and related parties did not engage in any arrangement with controlled or uncontrolled parties that circumvented the restriction, and did not materially violate the restriction.

3M's Position

- The agency discretion standard is set forth in *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005), relying on the framework set forth in *Chevron*.
  - The Court held that a "prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion."
- To support its position, 3M cited

  (1) the text of section 482;

  (2) the legislative history of section 482; and

  (3) four cases in which courts held that the IRS did not have authority to allocate income to a taxpayer that the taxpayer did not receive and could not legally receive.
    - (i) *L.E. Shunk Latex Prods., Inc. v. Commissioner*, 18 T.C. 940 (1952);
    - (ii) *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972);
    - (iii) *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); and
    - (iv) *Exxon Corp. & Affiliated Cos. v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993), *aff'd* sub nom. Texaco, Inc., & Subs. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

3M Regulation Validity

- Having rejected the argument that Treas. Reg. § 1.482-1(h)(2) is invalid under *Chevron* step one, the plurality then considered the argument that portions of the regulation are invalid under *Chevron* step two.
- A regulation satisfies *Chevron* step two if it is a "reasonable interpretation" of the statute. *Mayo Found. for Med. Educ. & Research*, 562 U.S. at 58; Chevron, 467 U.S. at 844.
- 3M argued that the first requirement of the regulation regarding the effect on uncontrolled taxpayers is invalid.
- While the plurality agreed that section 482 is aimed at controlled transactions, it stated that section 482 authorizes the IRS to allocate income among commonly controlled businesses if the allocation is necessary to clearly reflect income.

3M Notice and Comment Requirements

- 3M also argued that the foreign legal restriction regulation failed the test of *Motor Vehicle Manufacturers Association of the U.S., Inc. v. State Farm Mutual Automobile Insurance Co*., 463 U.S. 29 (1983), because Treasury did not provide a satisfactory explanation for its actions and did not provide adequate response to comments.
- The plurality stated that Treasury satisfactorily explained the reason for the regulation, which was to advance the goal of tax parity.
- The plurality also ruled that Treasury did adequately respond to comments.

Coca Cola blocked income issue

- In response to the decision in *3M Co. v. Commissioner*, 160 T.C. No. 3 (2023), Tax Court Judge Albert G. Lauber asked for supplemental briefings in *Coca-Cola Co. v. Commissioner*, 155 T.C. 145 (2020), which also involves a Brazilian legal restriction on the payment of some royalties.
- Coca-Cola argued that *3M* addressed the validity of the blocked-income provisions of the 1994 regulations under § 482, as amended in 1986 with the commensurate with income (CWI) provision.
  - The entire court in *3M* agreed that under § 482, before it was revised to include CWI, the Commissioner lacked the authority to tax blocked income under *First Security Bank*.
  - Coca-Cola argued that the pre-1986, single-sentence version of section 482 applied to licenses granted to foreign persons before November 17, 1985. The CWI language applies “only with respect to transfers after November 16, 1985, or licenses granted after such date.”

APA Developments

- On May 1 the IRS released interim guidelines (LB&I-04-0423- 0006) about the APMA's internal review and acceptance of APAs
  - The memo states that its purpose is not to provide substantive changes, but to boost early identification of potential roadblocks to successfully concluding a proposed APA and potential opportunities for other paths to certainty, such as the International Compliance Assurance Program (ICAP) or a joint audit
  - The memo outlines factors that the APMA should consider during its analysis, including:
    - the significance of the transaction;
    - whether there is a high probability that transfer pricing compliance will be significantly enhanced by engaging with the treaty partner;
    - whether there is a potential for the APA to affect prior tax years; and
    - whether ICAP participation, transfer pricing practice examination, or a joint audit**,** are instead suitable resolutions.
- Annual Advance Pricing Agreements Report (Announcement 2023-10): team leaders decrease and significant decrease in APAs executed and renewed from 2021 to 2022
- Eaton's APA case: Eaton Corp. argued in two U.S. Tax Court petitions that its court victories upholding APAs should help it overcome IRS transfer pricing determinations for tax years after those APAs had expired.

Sec. 367(d) Developments

IP Domestication

- In May, Treasury and the IRS issued proposed regulations on the repatriation of IP previously subject to Section 367(d). (REG-124064-19, federalregister.gov/d/2023-08843)
- The proposed regulations would replace portions of the "temporary" Section 367(d) regulations that have been in place since 1986.
- The proposed regulations would generally apply prospectively, to IP repatriations occurring on or after the date final regulations are published in the Federal Register.

IP Domestication

- The proposed 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 proposed 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 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 over the U.S. transferor's former 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.
  - 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 proposed 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 proposed 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 applicable rules.

IP Domestication Rulings

- In LTR 202334014 and LTR 202335001, the IRS ruled that after F reorganizations that repatriated intangible property, the section 367(d) deemed annual royalty payment was excluded from the U.S. parent's gross income under the consolidated return regulations.
- In both LTRs, the IRS ruled that each deemed royalty payment received following the F reorganizations is redetermined to be excluded from gross income under Treas. reg. section 1.1502-13(c)(6)(ii)(D).
- These rulings would be unnecessary if proposed regulations published May 3 (REG-124064-19) were finalized.

IRS Guidance

AM 2022-004, Active Trade or Business

- AM 2022-004 addresses the active trade or business (ATB) requirement under reg. section 1.367(a)-3(c)(3)(i)(A), stating that, as a general rule, an entity cannot satisfy the ATB requirement, barring exceptional circumstances, if it does not generate income for the entire 36-month period.
- Rev. Rul. 82-219, 1982-2 C.B. 82, a section 355 ruling, stated that the use of the word "ordinarily" indicates that there are exceptional situations in which there is no receipt of income and payment of expenses but there will still be an ATB under section 355(b). In that ruling, the company's only customer unexpectedly went bankrupt and its plant shut down.
- As a general rule, an entity cannot satisfy the ATB requirement if its activities are solely research and product development, and it does not generate income for the entire 36-month period. A pre-revenue corporation's lack of income while a product is being developed does not usually constitute an exceptional circumstance, according to the AM.
- *But cf* LTR 202340015, ruling that corporation that proposed to effect a tax-free spin off under § 355 satisfied the active trade or business requirement in respect of both the distributing and controlled businesses despite those businesses' lack of income generation. The taxpayer represented that for more than five years, employees have engaged in regular, continuing operational and managerial activities with respect to both subject businesses. But the taxpayer stated that it has not yet collected income associated with either business but had incurred substantial, continuing operating expenses representing the active conduct of a trade or business with respect to the businesses for each of the past five years.

Rev. Proc. 2022-39, Audit Disclosures

- Rev. Proc. 2022-39, 2022-49 IRB 1, sets forth new requirements and procedures for audit disclosures that are effective immediately. Rev. Proc. 94-69, 1994-2 C.B. 804, is now obsolete for audits beginning after November 16, 2022.
- Rev. Proc. 2022-39 makes the following changes:
  - To be eligible to make disclosures after the IRS contacts you about opening an audit, taxpayers must now meet a gating requirement: The taxpayer must have been audited four of the previous five years.
  - If eligible, taxpayers must make disclosures using Form 15307. The form instructions provide guidance and examples of what constitutes “adequate” disclosure.
  - If eligible, taxpayers have 30 days instead of 15 days to make the disclosures.
  - If the taxpayer has not been audited four of the last five years, post-tax return disclosures can be made by filing a full amended return before being contacted by the IRS about an audit and before the IRS takes other actions (for example, contacting a promoter). See reg. section 1.6664-2(c)(3). Disclosures are made so that accuracy-related penalties described in section 6662(b)(1) and (2) are not applicable.

AM 2023-001, Source of ADR Payments

- AM 2023-001 addresses the character and source of a U.S. depositary institution’s payments to a foreign corporation to establish sponsored American depository receipts (ADR) programs with holders located both inside and outside the United States, and payments by the depositary institution to the corporation under a revenue-sharing arrangement.
- The memo concludes that the United States — the location of the capital markets — is the place of use in this case and hence is the source of the ADR program payments.
- A fact upon which the AM is based is that both types of payments represent consideration for the depository institution’s right to establish, control, and exploit the trading of the foreign corporation’s ADRs in the United States. This right, according to the AM, constitutes a property right made available by the foreign corporation for use for a limited period of time solely in the United States, regardless of whether the holders are located inside or outside the United States, and thus both types of payments to the foreign corporation are treated as US source income and are subject to withholding of U.S. tax.
- The memo reasons that the United States — the location of the capital markets that the DI is accessing to profit from holders trading in ADRs and to which the U.S. securities laws apply — is the place of use in this case and hence is the source of the ADR program payments.

163(j) and 267(a)(3) Practice Units

- New IRS practice units describe the application of the interest expense deduction limitation rules of section 163(j) as applied to controlled foreign corporations and the interest expense limitation on related foreign party loans under section 267(a)(3).
- Charts in the section 163(j) practice unit compare the 2018 proposed regulations to the 2020 proposed regulations and the 2021 final regulations; and another compares 2020 proposed regulations to the 2021 final regulations.
- The section 267(a)(3) practice unit includes a lengthy discussion of situations in which a circular cash flow results in no interest payment being made (and thus no interest expense deduction being available) for U.S. tax purposes.

CFC Disaster Loss

- The taxpayer made an intriguing argument in ILM 202325007, where the IRS stated that certain CFC losses do not qualify as disaster losses under section 165(i)
- At issue was the the COVID-19 national emergency declaration issued by the president that declared all 50 states, the U.S. territories, and many tribes as COVID disaster areas.
- The U.S. owner of three CFCs claimed a worthless securities deduction under section 165(a) and (g) and (i)(1), immediately before the deemed liquidations of the CFCs.
- Section 165(i)(1) provides that, notwithstanding section 165(a), any loss occurring in a disaster area and attributable to a federally declared disaster may, at the election of the taxpayer, be taken into account for the tax year immediately preceding the tax year in which the disaster occurred.
- The legal memorandum states that business metrics would identify the location of the economic loss. Business metrics that might be applicable to a foreign corporation include income-producing assets, customers, employees, or revenue streams. None of the CFCs derived substantially all their revenues from U.S. customers. Other possible metrics, such as income-producing assets, employees, and revenue streams, all were located or occurred outside the United States.

Finalization of Consolidated Group Regs

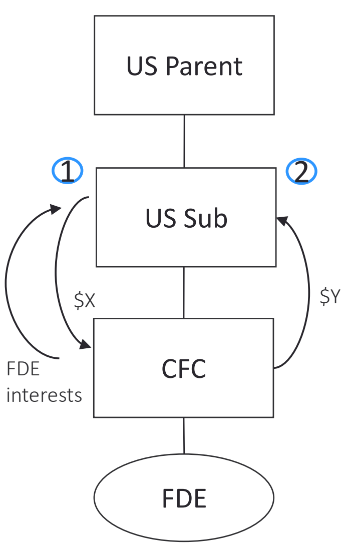
- IRS finalized regulations treating consolidated groups as a single shareholder when applying § 951(a)(2)(B) to distributions by a CFC of previously taxed earnings and profits (PTEP)
- Under new reg. section 1.1502-80(j), members of a consolidated group are treated as a single shareholder for determining the part of the year during which the shareholder did not own stock described in section 951(a)(2)(A).
- Regs are intended to stop taxpayers from taking the position that an intercompany transfer of lower tier CFC stock reduces the subpart F or GILTI inclusion of the consolidated group by the amount of distributions of PTEP made by the CFC during the tax year but before the intercompany transfer.

PTEP ruling regarding mid-year distribution

PTEP/Distribution Background

- Concerns that Treas. Reg. § 1.961-1 and -2 could result in basis decreases from PTEP distributions occurring before basis increases from GILTI and subpart F inclusions that occur in the same tax year.
- Treas. Reg. § 1.961-2(a)(1)- basis reduction resulting from distribution of PTEP occurs on the date of receipt
- Treas. Reg. § 1.961-1(a)(1) - basis increase from § 951 inclusions occurs "as of the last day in the taxable year of such [CFC] on which it is a controlled foreign corporation"

PLR 202304008 Facts

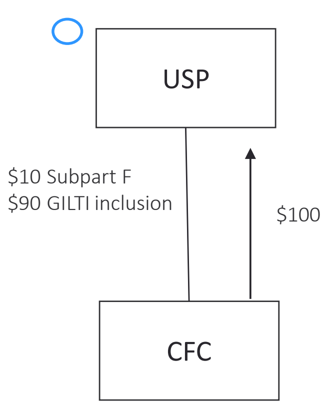


- CFC sold to US Sub all of the interests in a foreign disregarded entity (FDE) for cash
- In the same tax year, but after the sale, CFC distributed cash to US Sub.
- Parent and US Sub represented they will follow PTEP rules, maintain PTEP accounts in accordance with Notice 2019-01.
- US Sub represented it will include in its income for the year of the distribution subpart F and GILTI inclusions, giving rise to an increase to US Sub's PTEP accounts for CFC and an increase under section 961(a) in US Sub's adjusted basis in its CFC stock (the section 961(a) basis increase).
- The Distribution will include at least some PTEP.
- The Distribution will be the first actual or deemed distribution of the year from CFC to US Sub.

PLR 202304008 – IRS Ruling

- The IRS ruled that US Sub will take into account the section 961(a) basis increase when determining the reduction of the US Sub shares' adjusted basis under section 961(b)(1) (and gain recognition for the share under section 961(b)(2)) as a result of the distribution

AM 2023-002



- Follows the reasoning of LTR 202304008 in concluding that the positive basis adjustment from a GILTI inclusion should be taken into account before the negative basis adjustment from a mid-year distribution by a CFC
- Before the relevant year, USP's adjusted basis in its stock of CFC and USP's section 959 PTEP accounts for CFC were both $0.
- CFC had $10x of subpart F income & USP had GILTI inclusion of $90x
  - USP increased its PTEP accounts for FS by $100x as "Year 1 Inclusions."
- On June 30 in Year 1, CFC distributed $100 to USP
- At the end of Year 1, without diminution for distributions, CFC had E&P of $100x, and thus the midyear distribution would be, without regard to section 959(d), a dividend.
- The distribution was treated as an amount described in section 959(a). The entirety of the midyear distribution was excluded from USP's gross income. USP correspondingly decreased its PTEP accounts with respect to CFC by $100x.

AM 2023-002 Analysis

- The memo states that the timing rules in Treas. Reg. §§ 1.961-2(a) and -1(a) could be read to conclude that the adjusted basis of USP's CFC stock is computed before or after taking into account the $100 increase under § 961(a).
- The IRS determined that the better interpretation is that the increase in basis is taken into account when applying § 961(b)(2) and Treas. Reg. § 1.961-2(c) to the midyear distribution.
- The IRS further states that not doing so would produce discordance between sections 959 and 961

Attorney Bios

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 planning (inbound and outbound), mergers and acquisitions, and transfer pricing. 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 has recognized Julia, with clients stating that she "provides a great service." Julia was named as Tax Dispute Resolution Lawyer of the Year in 2021 and was shortlisted in the Tax Lawyer of the Year category in 2023, 2022, and 2020 by International Tax Review at the Americas Women in Business Law awards, and honored as one of the top 40 lawyers under 40 in the U.S. by the American Bar Association in 2018. She has appeared in Euromoney's Expert Guides and International Tax Review's Women in Tax Leaders.

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 International Fiscal Association, ITR, Pacific Rim Tax Institute, and Euromoney. 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 JioPlatforms, 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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