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INTERNATIONAL TAX ISSUES AND DEVELOPMENTS

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by

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I. THE INFLATION REDUCTION ACT.

A. Overview.

1. The Inflation Reduction Act (IRA, P.L. 117-169) became law on August 16, when it was signed by President Biden. The IRA was originally passed in the House in late 2021. A changed version was passed in the Senate on August 7, 2022, and the House approved the changes on August 12. The IRA adds $80 billion of funding to the IRS over the next ten years, with much of it going to enforcement. It also includes tax-related changes, notably:

   (a) a 15 percent corporate alternative minimum tax on certain large corporations;

   (b) a 1 percent excise tax on stock buybacks;

   (c) excise tax on drug manufacturers; and

   (d) electric vehicle and other clean energy tax credits.

2. Based on a version of the corporate AMT text before depreciation deduction changes were added to the IRA, as discussed further below, the Joint Committee on Taxation expected that this tax will raise $313 billion through 2031 from 150 taxpayers, which it subsequently updated to $222 billion. The JCT also stated that approximately half of this amount would have come from manufacturing companies before the depreciation deduction changes. If the JCT estimates are correct, and all else being equal, these 150 taxpayers will each pay approximately $1.5 billion in extra tax over the next nine years, or approximately $165 million more in taxes each year.

B. Corporate AMT.

1. Overview. The corporate AMT is added by amending section 55(b)(2) and is effective for tax years beginning after December 31, 2022. The provision adds a 15 percent corporate AMT on the "adjusted financial statement income" of "applicable corporations" after subtracting corporate AMT foreign tax credits. The minimum tax applies if it exceeds the regular tax amount, including any base erosion and antiabuse tax. Thus, taxpayers will have to consider their potential tax liability under three different regimes: the general regime, BEAT, and the corporate AMT, and pay the highest.

   This book minimum tax is a significant change because the base is adjusted financial statement income rather than taxable income. This essentially drags GAAP and other financial statement standards into the Tax Code with a heap of untested and unpredictable issues.

2. Applicable Corporation.

   (a) The definition of applicable corporation was added as a new section 59(k). An applicable corporation is a corporation with average annual

adjusted financial statement income of more than $1 billion (without loss carryovers) for a three-year period before the relevant tax year. At least one of the three years must end after December 31, 2021. For corporations that were formed less than three years ago, the average is applied to one or two years and financial statement income is annualized for short tax years. "Corporation" here excludes S corporations, regulated investment companies, and real estate investment trusts. Importantly, once a corporation is an applicable corporation, it is (generally) always an applicable corporation. This is similar to the familiar saying "once a PFIC, always a PFIC."

(b) Under some circumstances, a corporation is no longer treated as an applicable corporation if the Treasury Secretary determines that it would be inappropriate. This can occur if it has a change of ownership, so that the test must be reevaluated. This can also occur if the corporation has average annual adjusted financial statement income of less than $1 billion for a number of consecutive three-year periods to be set by the Secretary, including the most recent tax year. If a corporation meets the $1 billion average annual adjusted financial statement income test for any subsequent tax year, it will again be treated as an applicable corporation.

(c) To determine whether the $1 billion test is met, financial statement income of all persons treated as a single employer with the corporation under section 52(a) or (b) is combined. This includes all members of a controlled group of corporations with a 50 percent ownership overlap, by vote or value, and partnerships with common control, subject to specific rules.

(d) A U.S. corporate member of a foreign-parented multinational group is an applicable taxpayer if it has average annual adjusted financial statement income of $100 million or more (without loss carryovers) for the three-year period and its foreign-parented multinational group meets the $1 billion three-year average income threshold, without making specific adjustments required under the adjusted financial statement income rules that are discussed below. A foreign corporation's U.S. trade or business is treated as a U.S. corporation, which can result in a foreign-parented multinational group even if the foreign corporation does not otherwise have a U.S. corporate subsidiary.

(e) The IRA also states that the Secretary will issue regulations or other guidance to provide a simplified method for determining whether a corporation is an applicable corporation and that address how to apply the applicable corporation rules if a corporation undergoes a change in ownership.

3. Adjusted Financial Statement Income.

(a) Adjusted financial statement income is defined in a new section 56A and is the net income or loss on the taxpayer's applicable financial statement, with specific adjustments. Applicable financial statement is defined in section 451(b)(3) as, in order of priority: (A) a financial statement prepared in accordance with generally accepted accounting principles and is (i) a Form 10-K required by the SEC, (ii) an audited financial statement that is used for nontax purposes, or (iii) filed with another federal agency for nontax purposes; (B) a financial statement made on the basis of international financial reporting standards and is filed with a foreign governmental agency equivalent to the SEC with not less stringent reporting standards; or (C) a financial statement filed with any other regulatory or governmental body specified by the Secretary. The Secretary can specify otherwise in regulations.

(b) A number of adjustments must be made to the net income or loss on the taxpayer's applicable financial statement to determine adjusted financial statement income. The IRA indicates that appropriate adjustments must be made to adjusted financial statement income when an applicable financial statement period differs from the tax year, but no additional details are provided. If the applicable financial statement is for a group of entities, then rules similar to section 451(b)(5) must apply, which provides that this group's statement must be treated as the applicable financial statement of the taxpayer. For consolidated groups, adjusted financial statement income takes into account items on that group's applicable financial statement that are properly allocable to the group. If a corporation is not part of a consolidated group, then the only income from this corporation that is included in the adjusted financial statement income of the taxpayer is dividends received from that corporation (as reduced in regulations or other guidance issued by the Secretary) and other amounts includable in gross income or deductible as a loss (other than subpart F and global intangible low-taxed income inclusions under sections 951 and 951A, respectively, or other amounts provided by the Secretary).

(c) Unless otherwise provided by the Secretary, a partner's adjusted financial statement income is adjusted to only take into account the partner's distributive share of adjusted financial statement income of the partnership, which is the partnership's net income or loss on its applicable financial statement (adjusted under rules similar to these rules). This adjustment is ignored when considering whether a foreign-parented group meets the $1 billion threshold.

(d) If a taxpayer is a U.S. shareholder of a controlled foreign corporation, the taxpayer's adjusted financial statement income for that CFC is the income included under the special rule above regarding other corporations (that is, dividends and other amounts includable in gross

income or deductible as a loss), but adjusted to also take into account the taxpayer's pro rata share of items taken into account in computing the net income or loss on the CFC's applicable financial statement (as adjusted under rules similar to these rules). However, any negative adjustment, as determined on an aggregate basis of all CFCs, may not be used in the current year and must be carried forward to offset any future positive CFC related adjustment under this rule. This adjustment is ignored when considering whether a foreign-parented group meets the $1 billion threshold.

(e) In the case of a foreign corporation, to determine adjusted financial statement income, the principles of section 882 must apply, which results in taking into account only income that is effectively connected with the conduct of a U.S. trade or business, which is ignored when considering whether a foreign-parented group meets the $1 billion threshold. Also, adjusted financial statement income is altered to disregard any federal income taxes or income, war profits, or excess profits taxes within the meaning of section 901 relating to a foreign country or U.S. possession taken into account on the applicable financial statement, although corporate AMT foreign tax credits are later taken into account as described below. The Secretary may provide that foreign income taxes are taken into account if the taxpayer does not credit these taxes, but instead deducts them.

(f) Adjusted financial statement income also must include a disregarded entity's adjusted financial statement income, which may result in administrative ease and also, in some circumstances, additional foreign taxes being taken into account, as discussed below. Special rules also exist for cooperatives, Alaska Native Corporations, pension plans, and other specific situations.

(g) In addition, adjusted financial statement income is decreased to account for the tax depreciation deductions allowed under section 167 on section 168 tangible property instead of the financial statement depreciation. Adjusted financial statement income is also decreased by the tax amortization adjustments under section 197 relating to qualified wireless spectrum used in the trade or business of a wireless telecommunications carrier if the property was acquired after December 31, 2007, and before the enactment of the IRA (August 16, 2022), instead of the financial statement amortization.

(h) The IRA also gives the Secretary authority to issue regulations or other guidance to provide for adjustments to adjusted financial statement income as it determines is necessary to carry out the purposes of these rules, including adjustments to prevent omission or duplication of any items, and to carry out the principles relating to corporate liquidations, corporate organizations and reorganizations, and partnership contributions and distributions. There have already been requests for guidance relating to specific section

355 transactions that are tax-free for federal income tax purposes but can result in gain for financial statement purposes.

4. Further Adjusted Financial Statement Income Adjustments.

(a) NOLs. Adjusted financial statement income may be further reduced by the lesser of (a) the aggregate financial statement net operating loss carryovers to the tax year (starting with tax years ending after December 31, 2019), or (b) 80 percent of adjusted financial statement income. Any remaining net operating loss may be carried forward. This is important for corporations with significant NOLs from years before 2020 that are now profitable.

(b) Corporate AMT Foreign Tax Credit. As described above, the corporate AMT foreign tax credit is subtracted from the 15 percent corporate AMT on the adjusted financial statement income of applicable corporations. Section 59(*l*) is added to define the corporate AMT foreign tax credit as the amount equal to the sum of (A) all of the CFCs' aggregate foreign taxes (subject to a limitation) and (B) income, war profits, and excess profits taxes (within the meaning of section 901) taken into account on the applicable financial statement and paid or accrued by the applicable corporation. The CFCs' foreign taxes are determined as the lesser of (i) the aggregate of the applicable corporation's pro rata share of income, war profits, and excess profits taxes (within the meaning of section 901) that are taken into account on the CFCs' applicable financial statement and are paid or accrued by the CFCs, or (ii) 15 percent of the CFCs' adjusted financial statement income adjustments discussed above. As a result, a U.S. shareholder is limited to reducing its AMT by only the deemed-paid foreign income taxes actually paid or accrued, if less than 15 percent, and any amounts higher than 15 percent of the CFCs' adjusted financial statement income are excluded. In addition, the reference to section 901 allows for specific taxes to be taken into account here although otherwise prohibited from being creditable under specified provisions of section 901, such as section 901(m). As a result, for companies subject to the corporate AMT, it will be important to monitor and manage the impact of foreign tax credits.

(c) Carryforward.

i. Any foreign income taxes paid or accrued by a CFC that exceed 15 percent of the CFC's adjusted financial statement income adjustments can be carried forward for five years for purposes of this calculation.

ii. If minimum tax is higher than the regular tax, the net minimum tax can be carried forward as a credit to reduce regular tax, including any BEAT, in future years.

C. Stock Buyback Excise Tax.

1. The IRA adds a new section 4501 that includes a 1 percent excise tax on repurchases of corporate stock and applies to repurchases made after December 31. The tax is equal to 1 percent of the fair market value of any stock repurchased by a covered corporation during the tax year.

2. Although a covered corporation is a publicly traded domestic corporation, this excise tax can apply to: (1) an acquisition of stock of a publicly traded domestic corporation by a specified affiliate from another person; or (2) an acquisition of stock of an applicable foreign corporation by a specified affiliate from a person who is not the applicable foreign corporation or its specified affiliate. A specified affiliate is any corporation that is more than 50 percent owned, by vote or value, directly or indirectly, by the relevant corporation or any partnership more than 50 percent of the capital interests or profits interests of which are held, directly or indirectly, by the relevant corporation. An applicable foreign corporation is any publicly traded foreign corporation. These rules also apply to surrogate foreign corporations under the section 7874 rules, with some modifications. A repurchase is defined as a redemption under section 317(b) and any transaction that is determined by the Secretary to be economically similar. These rules do not apply:

   (a) to repurchases that are part of a reorganization under section 368(a) where no gain or loss is recognized on the repurchase by the shareholder;

   (b) if the stock repurchased (or an equal value of stock repurchased) is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or a similar plan;

   (c) if the total value of the stock repurchased during the tax year does not exceed $1 million;

   (d) under regulations, when the repurchase is by a dealer in securities in the ordinary course of business;

   (e) to repurchases by a regulated investment company or a REIT; or

   (f) to the extent the repurchase is treated as a dividend.

3. The excise tax is reduced by the FMV of any stock issued by the covered corporation during the tax year, including as stock-based compensation to employees of the covered corporation or a specified affiliate. This tax is not deductible.

4. The IRA provides that the Secretary is to issue regulations or other guidance necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this provision. These regulations can be to address prevention of abuse of the exceptions, to address special classes of stock and preferred

stock, and to apply the rules around the acquisition of stock of applicable foreign corporations.

II. PTEP PROPOSED REGULATIONS WITHDRAWN.

A. On October 20, the IRS announced withdrawal of proposed regulations from 2006 (REG-121509-00) that address the exclusion from gross income of previously taxed earnings and profits (PTEP) under section 959 and related basis adjustments under section 961. Those proposed regulations were never finalized, never went into effect, and did not indicate that taxpayers could rely on them. This follows the IRS' Notice 2019-01 (2019-02 I.R.B. 275), which announced that the IRS will withdraw these regulations and issue new proposed regulations. The new proposed regulations are intended to address some issues arising from the enactment of the Tax Cuts and Jobs Act (Pub. L. 115-97) regarding foreign corporations with PTEP.

B. The IRS stated that withdrawing the proposed regulations at this point will help prevent possible abuse or other misuse of them—such as inappropriate basis adjustments in certain stock acquisitions to which section 304(a)(1) applies—while the Treasury Department and the IRS continue to develop the new proposed regulations. Taxpayers have been waiting for updated PTEP regulations, which the IRS has stated are coming in 2023.

III. FOREIGN TAX CREDIT REGULATION UPDATES.

A. Overview. On July 27 the IRS released corrections to the final FTC regulations from early January (T.D. 9959), which were expected following an IRS official's comments earlier this year. These corrections primarily address the cost recovery requirement.

1. As corrected, reg. section 1.901-2 now provides that the cost recovery requirement is met even if recovery of certain costs is disallowed, as long as the disallowance under foreign law is "consistent with any principle underlying the disallowances required under the IRC, including the principles of limiting base erosion or profit shifting and public policy concerns." The technical correction provides four specific examples of disallowed deductions that do not violate the cost recovery rule:

    (a) limitations on interest deductions based on a measure of taxable income;

    (b) disallowance of deductions in connection with hybrid transactions;

    (c) disallowance of deductions attributable to excluded, exempt, or eliminated income; and

    (d) deduction disallowances based on public policy considerations similar to those under section 162.

2. The corrections also have approximately a couple dozen other predominantly technical corrections. The changes include revisions to the coordination with treaties paragraph in reg. section 1.901-2(a)(1)(iii).

IV. FINAL SECTION 958 REGULATIONS AND PROPOSED PFIC REGULATIONS.

A. Final Section 958 Regulations.

1. Overview.

(a) On January 25 Treasury and the IRS released final regulations (T.D. 9960) regarding the treatment of the ownership of foreign corporations by domestic partnerships and their partners (the 2022 final subpart F regulations). These regulations finalize portions of the proposed regulations (REG-101828-19) under sections 951, 951A, 954, 956, 958, and 1502 (the 2019 proposed subpart F regulations) published in June 2019.

(b) The 2019 proposed subpart F regulations were published at the same time as the final regulations in T.D. 9866 under sections 951, 951A, 1502, and 6038 (the 2019 final GILTI regulations) to generally achieve consistent treatment between subpart F and global intangible low-taxed income inclusions by domestic partners of domestic partnerships.

(c) The 2019 final GILTI regulations provided that a domestic partnership should be treated as an aggregate of all of its partners for purposes of computing income inclusions under section 951A. As a result, partners do not take into account a distributive share of the partnership's section 951A inclusion for the partnership-owned controlled foreign corporations, but instead are treated as proportionately owning the stock of the partnership-owned CFCs. A partner's GILTI inclusion under section 951 is thus determined at the partner level.

(d) The 2019 final GILTI regulations apply to tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which those tax years of the foreign corporations end.

2. Aggregate Treatment.

(a) Consistent with the approach in the 2019 final GILTI regulations, the 2022 final subpart F regulations generally finalize the portion of the 2019 proposed subpart F regulations that treat domestic partnerships as aggregates of their partners for purposes of determining income inclusions under section 951 and for purposes of provisions that apply specifically by reference to section 951.

(b) The 2022 final subpart F regulations provide that aggregate treatment of domestic partnerships applies for purposes of section 956(a) and any provision that specifically apply by reference to section 956(a). This was needed because section 956 itself does not specifically apply by referencing section 951 or section 951A.

(c) However, aggregate treatment does not apply for purposes of section 956(c), which defines U.S. property, or section 956(d), which requires pledges and guarantees of a CFC to be considered when determining whether obligations are U.S. property (or provisions that apply by reference to these sections). The preamble states that treating a domestic partnership as an entity separate from its partners is more appropriate to carry out the purposes of these provisions.

(d) The 2022 final subpart F regulations revise the language in reg. section 1.958-1(d) to provide that the aggregation rules for partnerships apply to any provisions that "specifically" apply by reference to sections 951, 951A, or 956(a), or reg. section 1.958-1(d). This change from the proposed regulations is to make clear that the new rules do not apply in all circumstances but only when these sections or related regulations are specifically cross-referenced.

(e) The 2022 final subpart F regulations, consistent with the 2019 proposed subpart F regulations, do not extend the aggregate treatment for determining the controlling domestic shareholders of a CFC under reg. section 1.964-1(c)(5)(i). This is relevant for making some CFC elections, such as electing the method of calculating the CFC's earnings and profits under section 964(a) and electing to exclude tentative gross tested income items from gross tested income under section 951A(c)(2)(A)(i)(III). This makes sense because these often important elections are able to be handled at the level of the partnership, which often will be a fund.

(f) Under reg. section 1.964-1(c)(5)(i), the controlling domestic shareholders of a CFC are the U.S. shareholders that, in the aggregate, own (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the CFC entitled to vote and that undertake to act on the CFC's behalf. If the ownership requirement is not satisfied, the controlling domestic shareholders of the CFC are all of the U.S. shareholders that own (within the meaning of section 958(a)) stock of the CFC.

(g) However, this approach is proposed to be revised in the 2022 proposed passive foreign investment company regulations discussed below so that reg. section 1.958-1(d)(2) would require aggregate treatment to apply for purposes of determining the controlling domestic shareholders of a CFC under reg. section 1.964-1(c)(5). This means that the relevant domestic partners, not the domestic

partnership, are proposed to be considered when determining controlling domestic shareholders.

(h) Treasury and the IRS did not address how to approach the transition of previously taxed E&P accounts under section 959 and related basis adjustments under section 961, which were made at the partnership level, to the partner level under the aggregate approach. They intend to address this in future guidance.

(i) Interaction of the aggregate approach and section 1248 (including for dispositions by domestic partnerships of CFC stock), dispositions of interests in domestic partnerships that own CFC stock, and the interaction between section 1248 and section 751 also were not addressed in these regulations. However, the final regulations clarify that the aggregate approach in reg. section 1.958-1(d)(1) does not apply for purposes of section 1248 to be consistent with the intended scope of the rules as described in the preamble to the 2019 subpart F proposed regulations. The final regulations do not affect the application of reg. section 1.1248-1(a)(4), which addresses the consequences of a foreign partnership's sale of stock.

(j) Aggregate treatment is not extended to domestic non-grantor trusts and domestic estates in the 2022 final subpart F regulations.

3. Applicable Dates.

(a) The regulations apply to tax years of foreign corporations beginning on or after January 25, 2022, and to tax years of U.S. persons (partners) in which or with which the foreign corporation's tax year ends.

(b) The preamble also discusses the application of the 2019 proposed subpart F regulations at length. Prop. reg. section 1.958-1(d)(4) provided that the regulations under section 958 would apply to tax years of foreign corporations beginning on or after the date the final regulations are published and to tax years of U.S. persons in which or with which such tax years of the foreign corporations end. However, domestic partnerships could apply the regulations, when finalized, to tax years of a foreign corporation beginning after December 31, 2017, and to tax years of the domestic partnership in which or with which the tax years of the foreign corporation end, subject to the requirement that the partnership, its U.S. shareholder partners, and other related domestic partnerships and their U.S. shareholder partners consistently apply the regulations for all foreign corporations the partnerships own (the pre-finalization applicability option). The 2019 proposed subpart F regulations also permitted domestic partnerships, their U.S. shareholder partners, and related domestic partnerships and their U.S. shareholder partners to rely on

prop. reg. section 1.958-1(d)(4), subject to the same consistency requirement (the reliance option).

(c) A commentator pushed back on the complexity of the pre-finalization applicability and reliance options resulting from requiring numerous unrelated partners to agree and proposed a simpler approach in which consistency would be required only for related partners or at least allowing the partnership to make an election.

(d) Treasury and the IRS rejected these proposals, stating that the difficulty posed by an individualized approach outweighs the potential benefit the approach would provide to a partner, although they understand that these requirements may be difficult to meet in more widely held partnership structures. As a result, the 2022 final subpart F regulations incorporate the pre-finalization applicability option and the reliance option from the 2019 proposed subpart F regulations without changes.

(e) The preamble stated that, subject to the consistency requirement, a domestic partnership may apply the regulations on an amended return or through initiating an administrative adjustment request under section 6227. In instances in which a domestic partnership files an amended return (that is, in the case of partnerships not subject to sections 6221 through 6241), its partners (both U.S. and non-U.S. shareholder partners) will likely need to also file amended returns to satisfy the consistency requirement.

(f) Prop. reg. section 1.958-1(d)(4) provided that reg. section 1.958-1(d), when finalized, would apply to tax years of foreign corporations beginning on or after the date the final regulations are published and to tax years of U.S. persons in which or with which the tax years of the foreign corporations end. A commentator noted that, under this rule, in some circumstances in which a fiscal-year U.S. shareholder partnership with U.S. shareholder partners has a different tax year than its CFC and U.S. shareholder partners, the applicability date could cause the U.S. shareholder partners to have two years of section 951 inclusions in the same tax year for the same CFC — that is, a distributive share of the partnership's section 951 inclusion from the CFC's last tax year before the application of the final regulations, and a direct section 951 inclusion for the first tax year of the CFC subject to the final regulations.

(g) Treasury and the IRS said that they intended this result and that the adoption of the aggregate approach is not a change in method of accounting. As a result, in the first tax year to which the aggregate approach applies, the U.S. shareholder partner could have two section 951 inclusions: (1) its distributive share of the partnership's section 951 inclusion for the CFC's last tax year that begins before January 25, 2022; and (2) its own section 951 inclusion for the CFC's

first tax year beginning on or after January 25, 2022. The preamble states that these inclusions represent subpart F income for two different tax years of the CFC, and therefore there is no duplication or omission of the CFC's subpart F income to the U.S. shareholder partner.

B. Proposed PFIC Regulations.

1. Overview.

(a) Concurrently with the release of the subpart F final regulations in T.D. 9960, Treasury and the IRS released proposed regulations (REG-118250-20) to predominantly address PFIC inclusions and related elections for foreign corporations held by domestic partnerships, S corporations, and their partners and shareholders. These proposed regulations would alter the PFIC rules to be consistent with the approach in the 2019 final GILTI regulations and the 2022 final subpart F regulations to treat domestic partnerships as aggregates of their partners (and for S corporations, of their shareholders) for purposes of determining income inclusions and making various elections under the PFIC rules.

(b) These changes would result in affected partners needing to diligently monitor when PFIC-related elections — including qualified electing fund elections — need to be made, as these elections would no longer be able to be made by the partnership. As a substantive matter this change makes sense—affected partners will often have differing interests and risk tolerances in determining the advisability of making a QEF, or a protective QEF, election. But partners need to be advised that the power of making an election is in their hands.

(c) The proposed regulations would generally apply to tax years beginning on or after the date they are finalized.

(d) Under current final reg. section 1.1291-1(b)(7), a shareholder of a PFIC generally is defined as a U.S. person that owns PFIC stock directly, or indirectly through corporations or passthrough entities (an indirect shareholder), within the meaning of section 1298(a) and reg. section 1.1291-1(b)(8) (collectively, a PFIC shareholder). For purposes of sections 1291 and 1298, neither a domestic partnership nor an S corporation is treated as a PFIC shareholder except for purposes of any information reporting requirements (including the requirement to file an annual report under section 1298(f)) or as otherwise explicitly provided in regulations.

(e) Reg. section 1.1291-1(b)(8)(iii)(A) and (B) provides that if a domestic partnership or S corporation owns PFIC stock, the partners or S corporation shareholders are considered to own the PFIC stock proportionately in accordance with their ownership interests. As a

result, if a domestic partnership or S corporation owns PFIC stock, the excess distribution PFIC rules apply at the partner or S corporation shareholder level.

(f) The proposed regulations update the definition of shareholder under reg. section 1.1291-1(b)(7) to reflect aggregate treatment for purposes of the PFIC regime. Under the proposed rules, neither domestic partnerships nor S corporations are considered shareholders for purposes of making QEF or mark-to-market (MTM) elections, recognizing QEF inclusions or MTM amounts, making PFIC purging elections, or filing Forms 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

2. QEF Elections.

(a) Under current rules, domestic partnerships and S corporations are treated as PFIC shareholders for purposes of the QEF rules under reg. section 1.1295-1(j). As a result, a domestic partnership or S corporation that owns PFIC stock generally makes the QEF election for the PFIC under reg. section 1.1295-1(d)(2)(i)(A) and (ii). Also, reg. section 1.1293-1(c)(1) provides that the domestic partnership or S corporation recognizes any QEF inclusions at the entity level, and each U.S. person that is an interest holder in the domestic partnership or S corporation takes into account its pro rata share of the inclusions.

(b) One commentator recommended a transition to an aggregate approach to QEFs with an alternative that would permit a domestic partnership to make a QEF election on behalf of its partners if permitted under the partnership agreement. However, Treasury and the IRS stated in the preamble that aggregate treatment is consistent with the general treatment of partnerships for purposes of the PFIC regime under section 1298(a)(3) and aligns the QEF rules with the CFC overlap rule. As a result, partners will be required to make the election. The preamble also stated that the new reporting by partnerships on Schedule K-2, "Partners' Distributive Share Items — International," and Schedule K-3, "Partner's Share of Income, Deductions, Credits, etc. — International," is expected to facilitate a partner's ability to make the QEF election. The preamble requests comments on whether the final regulations should permit a domestic partnership-level or S corporation-level QEF election on behalf of its partners or shareholders.

(c) Under this new regime, if there are nonconforming tax years between a partner and a partnership, the partner may be required to file its return to make a QEF election (and include its QEF inclusion) before the deadline for the partnership to provide it with Schedule K-3. In this case, the partner seeking to make a QEF election may want to

coordinate with the partnership to provide the partner with the necessary information in a timely fashion.

(d) Because the proposed regulations provide that a partner or S corporation shareholder — rather than the domestic partnership or S corporation — makes a QEF election, each electing partner or S corporation shareholder must notify the partnership or S corporation of the election to assist the partnership or S corporation with information reporting and tracking basis in the QEF stock. Under the proposed rules, partners and S corporation shareholders must include their pro rata shares of ordinary earnings and net capital gain attributable to the QEF stock as if such shareholder owned its share of the QEF stock directly and not as a share of the passthrough entity's income.

(e) However, contrary to the current regulations a QEF election made under prop. reg. section 1.1295-1(d)(2)(i)(A) or (ii)(A) by a partner or S corporation shareholder for PFIC stock held indirectly through a domestic partnership or S corporation applies to all stock of that PFIC owned by the partner or S corporation shareholder, even if owned outside of the partnership or S corporation.

(f) Under current final reg. section 1.1293-1(c)(2)(i), if PFIC stock subject to a QEF election is transferred to a domestic passthrough entity of which the transferor is an interest holder, and the transferee passthrough entity makes a QEF election for the PFIC, thereafter the transferor and other interest holders that become PFIC shareholders as a result of the transfer begin taking into account their pro rata shares of the passthrough entity's QEF inclusions. However, under reg. section 1.1293-1(c)(2)(ii), if the transferee passthrough entity does not make a QEF election for the transferred PFIC, the transferor-shareholder (but not other indirect shareholders resulting from the transfer) continues to be subject to QEF inclusions for the PFIC.

(g) The proposed regulations, on the other hand, provide that, if a shareholder transfers stock of a PFIC with a QEF election to a passthrough entity, the transferor continues to be subject to QEF inclusions. However, the other interest holders are subject to QEF inclusions from the PFIC only if they make QEF elections on the transferred stock.

(h) The proposed rules also address domestic non-grantor trusts, which continue to be shareholders for purposes of the QEF rules, so that the rules applicable to partnerships and S corporations and their partners and shareholders generally do not apply to domestic non-grantor trusts, with some exceptions.

(i) A grandfathering rule exists for existing QEF elections. QEF elections made by a domestic partnership or S corporation that are effective for

tax years of a PFIC ending on or before these regulations are finalized (such PFIC a preexisting QEF and the election a preexisting QEF election) will continue for any partner or S corporation shareholder owning an interest in a preexisting QEF on that date. However, the partner or S corporation shareholder will be subject to QEF inclusions under the new aggregate approach.

(j) The proposed regulations also make several modifications to the rules that characterize stock held through a passthrough entity under reg. section 1.1295-1(b)(3)(iv). The rule now governs how stock of a PFIC will be treated as stock of a pedigreed QEF to a shareholder, as defined in prop. reg. section 1.1295-1(j)(3), rather than all interest holders or beneficiaries of a passthrough entity as under the current provision.

(k) The proposed regulations also make several changes to conform reg. section 1.1295-1 to the general aggregate treatment of domestic passthrough entities (other than domestic non-grantor trusts and domestic estates) under the QEF rules. These changes include:

i. limiting the application of the rules described above to domestic non-grantor trusts and domestic estates, which are the only domestic passthrough entities that may make a QEF election under the proposed regulations;

ii. applying the partnership termination rule only for partnerships that have made preexisting QEF elections and their partners;

iii. revising rules governing the treatment of PFIC stock distributed by a partnership as stock of a pedigreed QEF to transferee partners; and

iv. providing that shareholders owning QEF stock through a domestic partnership or S corporation that has made a preexisting QEF election are required to file Form 8621 for such QEFs.

(l) The proposed regulations remove the rule in reg. section 1.1295-1(i)(1)(ii) that allows the IRS commissioner to invalidate a passthrough entity QEF election for a shareholder if, as a result of nonconforming tax years between the shareholder and a passthrough entity, the QEF inclusion is not included in income within two years of the PFIC's year end. The commissioner continues to have discretion to invalidate or terminate a shareholder's QEF election in appropriate circumstances if the requirements of section 1295 are not met by a shareholder, an intermediary, or the relevant PFIC.

3. MTM Elections.

(a) For administrability-related reasons similar to those noted for QEFs, some commentators recommended maintaining entity treatment of domestic partnerships under the MTM rules in section 1296. However, Treasury and the IRS concluded that domestic partnerships and S corporations should also be treated as aggregates for purposes of the MTM rules. Partners and S corporation shareholders making an MTM election for a PFIC held through a partnership or S corporation must also notify the partnership or S corporation of the election. Incorporating the prop. reg. section 1.1291-1(b)(7) definition of shareholder into reg. section 1.1296-1 also clarifies that the MTM rules apply to grantors of domestic grantor trusts that own PFIC stock, and that domestic non-grantor trusts and domestic estates continue to be treated as entities for purposes of the MTM rules.

(b) Treasury and the IRS have concluded that MTM elections made for a PFIC by a domestic partnership or S corporation for tax years of the PFIC ending on or before these regulations are finalized should be treated as made by any partner or S corporation shareholder owning its interest on that date. MTM elections made by domestic partnerships and S corporations effective for tax years of a PFIC ending on or before finalization of the proposed regulations under section 1.1296-1(h)(1)(i)(A) continue to be valid and will be treated as made by the owners. As a result, going forward the owners will determine their MTM gain or loss as if they held the section 1296 stock directly.

(c) Under section 1296(j) and reg. section 1.1296-1(i), if a taxpayer makes an MTM election for a foreign corporation that was a PFIC (other than a QEF) before the first tax year to which the MTM election was effective, the excess distribution rules apply to any (1) distributions by the PFIC for the section 1296 stock; (2) disposition of the section 1296 stock; and (3) MTM gain recognized on the last day of the U.S. person's tax year.

(d) The proposed regulations clarify that this MTM coordination rule is applied to a PFIC shareholder. To coordinate with MTM rules other than those under section 1296, the proposed regulations also modify reg. section 1.1291-1(c)(4)(ii) so that computations apply to PFIC shareholders.

4. CFC Overlap Rule.

(a) Under current final section 1297(d), a foreign corporation that is both a CFC and a PFIC is not considered to be a PFIC for a shareholder during the shareholder's qualified portion (as defined in section 1297(d)(2)) of its holding period (the CFC overlap rule). The term "qualified portion" generally means the portion of the shareholder's

holding period during which the shareholder is a U.S. shareholder for the PFIC and during which the PFIC is also a CFC. Thus, this rule applies separately for each shareholder of the foreign corporation, and the foreign corporation may be a PFIC for one shareholder but not another.

(b) The preamble states that a U.S. person that is not a U.S. shareholder of a foreign corporation that would otherwise be a PFIC if held directly by that person should not be permitted to rely on the CFC overlap rule to avoid the PFIC regime simply because the U.S. person owns its interest in the foreign corporation indirectly through a domestic partnership or S corporation.

(c) The preamble states that, although section 1297(d) does not define the term "shareholder" for this purpose, under reg. section 1.1291-1(b)(7), a domestic partnership or S corporation is not a shareholder to which the CFC overlap rule applies.[1] The preamble further states that consistent with the aggregate approach to section 951 and section 951A in applying the CFC overlap rule under the existing regulations, the proposed regulations confirm that for purposes of section 1297(d), the term "qualified portion" does not include any portion of a domestic partner or S corporation shareholder's holding period during which the partner or shareholder was not a U.S. shareholder of the CFC/PFIC.

(d) The preamble further provides that under entity treatment for subpart F, the CFC overlap rule would not apply to partners or S corporation shareholders of the CFC/PFIC that were not U.S. shareholders even though they would include their share of inclusions of the domestic partnership or S corporation under sections 951 and 951A. Under this approach, the CFC/PFIC would be treated as a PFIC for these partners or S corporation shareholders even though the partner or shareholder was subject to current inclusions under the subpart F regime.

(e) Treasury and the IRS determined that it is appropriate to provide a transition rule that would apply to tax years of shareholders beginning before the date these regulations are finalized or for tax years of shareholders of an S corporation in which the S corporation elects to apply reg. section 1.958-1(e). When this transition rule applies, the CFC overlap rule would apply to specified persons that are indirect PFIC shareholders, but not U.S. shareholders, as a result of owning stock of foreign corporations through domestic partnerships or S corporations during periods when the shareholder was subject to current inclusions under section 951 or 951A (for example, under the rules described in Notice 2019-46, 2019-37 IRB 695, and Notice 2020-69, 2020-39 IRB 604) as a share of a domestic partnership or S

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[1] But see, e.g., LTR 201108020 and LTR 200943004, in which the IRS ruled that the partners in a U.S. partnership could enjoy overlap rule protection.

corporation's income inclusions. However, this rule would not apply to the extent that the partnership adopted the 2022 final subpart F regulations prior to their effective date in 2023.

5. Purging Elections.

(a) Under current law, domestic partnerships and S corporations also generally make elections to "purge" the PFIC taint so it is no longer subject simultaneously to the excess distribution and QEF rules (section 1291 purging elections) and either deemed sale elections or deemed dividend purging elections (section 1298 purging elections; together, the PFIC purging elections).

(b) Consistent with the above, Treasury and the IRS determined that the purging elections for PFICs owned by partnerships and S corporations should be made at the partner or shareholder level because each of the PFIC purging elections can result in the recognition of excess distributions under section 1291, and those inclusions are directly taken into account at the partner or shareholder level and rely on partner or shareholder-specific tax attributes, such as holding period.

6. Information Reporting.

(a) Under the current final rules, a U.S. person that is a PFIC shareholder must file Form 8621 under reg. section 1.1298-1(b)(1) if, during the shareholder's tax year, it is:

i. a direct PFIC shareholder;

ii. an indirect PFIC shareholder that holds any interest in the PFIC through one or more foreign entities; or

iii. an indirect PFIC shareholder that is treated as the owner of any portion of a domestic grantor trust that owns stock of a PFIC directly or through one or more foreign entities.

(b) Also, under the current final rules, an indirect PFIC shareholder that owns stock of a PFIC through one or more U.S. persons must file Form 8621 for the PFIC if, during the indirect shareholder's tax year, it is:

i. treated as receiving an excess distribution from the PFIC;

ii. treated as recognizing gain that is treated as an excess distribution as a result of a disposition of the PFIC;

iii. required to recognize QEF inclusions under section 1293(a);

iv. required to include or deduct MTM amounts under section 1296(a); or

v. required to report the status of an election under section 1294 for the PFIC.

(c) However, under reg. section 1.1298-1(b)(2)(ii), an indirect PFIC shareholder that is required to either recognize QEF inclusions under section 1293(a) or MTM amounts under section 1296(a) is generally not required to file Form 8621 if another PFIC shareholder through which the indirect PFIC shareholder owns its interest in the PFIC timely files Form 8621. Thus, if an indirect PFIC shareholder is treated as owning an interest in a PFIC by reason of an interest in a domestic partnership or S corporation and the domestic partnership or S corporation recognizes QEF inclusions or MTM amounts and timely files Form 8621, the indirect PFIC shareholder is generally not required to file Form 8621.

(d) Treasury and the IRS concluded that domestic partnerships and S corporations should no longer be required to file an annual report (Form 8621) under section 1298(f) and reg. section 1.1298-1. The requirement to file Form 8621 applies only to PFIC shareholders within the meaning of reg. section 1.1291-1(b)(7), which includes, for example, partners or S corporation shareholders that indirectly own PFICs through domestic partnerships or S corporations. Domestic partnerships and S corporations will not be subject to this filing obligation because of the revised definition of shareholder in prop. reg. section 1.1291-1(b)(7), under which domestic partnerships and S corporations are not PFIC shareholders for any purpose.

(e) To reflect this, prop. reg. section 1.1298-1(b)(1)(i) and (ii) provides that the general rule concerning who has to file Form 8621 is either a direct PFIC shareholder, or an indirect PFIC shareholder (within the meaning of reg. section 1.1291-1(b)(8)) that holds an interest in a PFIC through one or more entities, each of which is not a PFIC shareholder within the meaning of reg. section 1.1291-1(b)(7).

(f) While these changes represent a change in the PFIC shareholders required to file an annual report under section 1298(f), a domestic partnership or S corporation will continue to have a responsibility to report information for PFICs it owns to its interest holders on Schedule K-3 of Form 1065, "U.S. Return of Partnership Income," or Form 1120-S, "U.S. Income Tax Return for an S Corporation," when required.

J. Other Changes.

(a) The term "post-1986 E&P" is the basis upon which a deemed dividend under reg. sections 1.1291-9, 1.1297-3, and 1.1298-3 is determined, and each of those sections generally defines the term by reference to the definition of "undistributed earnings, within the meaning of section 902(c)." However, because section 902 was

repealed by the 2017 Tax Cuts and Jobs Act, the proposed regulations revise the definition of post-1986 E&P in reg. sections 1.1291-9(a)(2)(i), 1.1297-3(c)(3)(i)(A), and 1.1298-3(c)(3)(i) to eliminate references to section 902(c) and to define the term by reference to E&P computed in accordance with sections 964(a) and 986.

(b) As discussed above regarding the 2022 final subpart F regulations, the proposed regulations also include modifications to reg. section 1.964-1(c) in determining controlling domestic shareholders of CFCs to be consistent with the treatment of domestic partnerships as aggregates for purposes of subpart F and GILTI inclusions. Accordingly, prop. reg. section 1.958-1(d)(1) provides that domestic partnerships are not considered to own stock of a foreign corporation under section 958(a) for purposes of reg. section 1.964-1(c) as well as any provision that specifically applies by reference to reg. section 1.964-1(c). As a result, domestic partnerships and S corporations (by virtue of section 1373(a)) would be treated as aggregates of their partners and shareholders for purposes of determining the controlling domestic shareholders of foreign corporations under the proposed regulations.

(c) In addition to applying for purposes of determining the controlling domestic shareholders of a foreign corporation, aggregate treatment also generally applies for purposes of the notice requirement of reg. section 1.964-1(c)(3)(iii). The preamble provides that extending aggregate treatment to this notice requirement ensures that other persons known by the controlling domestic shareholders to be U.S. persons that own (within the meaning of section 958(a)) stock of a foreign corporation (domestic shareholders) through a domestic partnership (but are not themselves controlling domestic shareholders) are made aware of any action undertaken by the controlling domestic shareholders under reg. section 1.964-1(c)(3).

(d) Prop. reg. section 1.964-1(c)(3)(iii)(B) provides that a controlling domestic shareholder is deemed to satisfy the notice requirement for domestic shareholders that are partners in a domestic partnership by providing the notice to the domestic partnership (known to the controlling domestic shareholder) through which the domestic shareholders own stock of the foreign corporation, which could then provide the notice to its partners that are domestic shareholders. Also, to help facilitate notice to the person who prepares and maintains the foreign corporation's books and records for U.S. federal income tax purposes, notice is also required to be provided to any U.S. person (such as a domestic partnership) that controls, within the meaning of section 6038(e), the foreign corporation (in other words, any U.S. person that is a category 4 filer of Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," regarding the foreign corporation).

(e) The proposed regulations also include the rules announced in Notice 2019-46 that permit domestic partnerships and S corporations to apply the hybrid approach for tax years ending before June 22, 2019. Consistent with Notice 2019-46, to apply the hybrid approach, domestic partnerships and S corporations must satisfy notice requirements. Also, if the domestic partnership or S corporation satisfies these notification requirements it will not be subject to penalties for failures to file or furnish statements to the extent such failures arise from acting consistently with the 2018 proposed regulations before June 22, 2019.

(f) The proposed regulations also include changes to the net investment income tax rules. Under the current rules, an election under reg. section 1.1411-10(g) can be made for a CFC or PFIC that is a QEF to treat amounts included in income under section 951(a) or section 1293(a)(1)(A) as net investment income for purposes of reg. section 1.1411-4(a)(1)(i) and to take amounts included in income under section 1293(a)(1)(B) into account for purposes of calculating the net gain attributable to dispositions of property under reg. section 1.1411-4(a)(1)(iii).

(g) In accordance with reg. section 1.1411-10(g)(3), the election may be made by any individual, estate, trust, domestic partnership, S corporation, or common trust fund that owns the relevant CFC or QEF directly, or indirectly through one or more foreign entities. If a domestic partnership, S corporation, estate, trust, or common trust fund that directly owns the CFC or QEF does not make the election, an individual, estate, trust, domestic partnership, S corporation, or common trust fund that owns the CFC or PFIC indirectly through the nonelecting entity may itself make the election.

(h) Treasury and the IRS determined that elections under reg. section 1.1411-10(g) should no longer be permitted to be made by a domestic passthrough entity but instead should be made only by an individual, estate, or trust that holds the CFC or QEF indirectly through the domestic passthrough entity. The preamble provides that this rule permits the election to be made solely by the person whose tax liability is directly affected by the election.

(i) However, for tax years that an S corporation elects to be treated as an entity under prop. reg. section 1.958-1(e), the S corporation may make the election under reg. section 1.1411-10(g) for CFCs it owns, directly or indirectly; if the S corporation does not make the election under reg. section 1.1411-10(g), its shareholders that are individuals, estates, or trusts may make it instead.

(j) The proposed regulations also include rules addressing the determination and inclusion of related-person insurance income under section 953(c) for domestic partnerships and their partners.

V. RECENT INTERNATIONAL TAX CASES.

A. Exxon Has Mineral Leases, Not Sales.

1. The Fifth Circuit ruled that Exxon had mineral leases, not mineral sales, in *Exxon*.[2] The court denied Exxon's claim for a refund of approximately $1 billion and affirmed the decision of the U.S. District Court for the Northern District of Texas.

2. Exxon entered into agreements with Qatar and Malaysia to commodify their offshore oil-and-gas deposits. The Qatari agreements grant Exxon rights to explore a large offshore gas field within Qatar's territorial waters. The agreements last for fixed terms, typically 20 years. In exchange for mineral rights, Exxon extracted gas and paid Qatar royalties based on the petroleum products it produced. These royalties included a percentage of the proceeds from the sale of petroleum products as well as a minimum amount based on how much gas Exxon brought in. Exxon was also required to build and operate facilities to transport, store, process, and market its products. Exxon invested $20 billion in this infrastructure and produced petroleum products that were 20 times as valuable as gas. When the agreements end, Qatar will keep the infrastructure.

3. The Malaysian agreements give Exxon rights to extract offshore minerals. In exchange, Malaysia is entitled to a set percentage of the oil extracted and additional payments based on how much oil is produced. In addition, Exxon must make annual "abandonment cess" payments that do not depend on mineral production to fund the costs of plugging wells at the end of their useful lives. Exxon developed considerable extraction, transportation, storage, and processing infrastructure in Malaysia, which will revert to the state after the contracts expire.

4. For mineral leases, the transferor's income from minerals is treated as ordinary taxable income. The portion of the overall income from minerals is included only in the transferor's taxable income and excluded from the transferee's taxable income. The transferor and transferee are each entitled to depletion deductions to the extent of their interest in the minerals. However, for mineral sales, the transferor only realizes income at the time of the sale. Income derived from the extraction of minerals is included in the transferee's taxable income, and only the transferee is entitled to depletion deductions.

5. Exxon filed its 2006 to 2009 tax returns treating its mineral transactions with Qatar and Malaysia as leases. Thus, it did not include in its taxable income the portion of mineral-based income that it paid to Qatar and Malaysia as royalties. Exxon later amended its returns, treating the mineral transactions as sales. Exxon's taxable income increased because it now included all the income derived from minerals, including the royalties paid to Qatar and

[2] *Exxon Mobil Corp. v. United States*, No. 21-10373 (5th Cir. 2022), *aff'g*, *Exxon Mobil Corp. v. United States*, No. 3:16-cv-02921 (N.D. Texas 2021).

Malaysia, and it in turn deducted some of the royalty payments it made to Qatar and Malaysia. Exxon also claimed FTCs relating to the income that was included in the amended returns, which gave rise to the refund request. The IRS rejected Exxon's refund claim and imposed a $200 million penalty for Exxon's claiming an excessive refund without a reasonable basis. Exxon paid the penalty and filed a refund action in district court.

6. The district court ruled in the government's favor on the lease-versus-sale issue and held that the transaction was a lease. On the penalty issue, however, the court held for Exxon and ordered a refund.

7. The district court looked to the "predominant or primary purpose" of the agreements to conclude that they are leases. The Fifth Circuit stated that "predominant purpose" analysis is inapplicable and the correct benchmark is the economic-interest test. The Fifth Circuit looked to whether Qatar and Malaysia retained an economic interest in the mineral deposits to determine if the agreements were leases.

8. The Fifth Circuit stated that an "economic interest" is a right to share in the profits and losses of a business, with ownership of stock as an example. The court also cites to reg. section 1.611-1(b)(1), which are allowance of deduction for depletion regulations, in its analysis that to have an economic interest in minerals in place, a person must have (1) an investment in the minerals and (2) income derived solely from extraction of the minerals.

9. The court found that Qatar and Malaysia retained an economic interest. Qatar received a percentage of the proceeds from the sale of petroleum products and an additional amount that depends on how much gas Exxon delivers to its Qatari facilities. Malaysia is entitled to a set percentage of oil extracted from the Malay Basin, plus additional payments that turn on how much oil and gas is produced.

10. The court further noted in a footnote that not everyone that benefits financially from the extraction of minerals has an economic interest. It provided as an example an operator of a gas processing plant that is contractually "entitled to a delivery of the gas" produced at specified wells. Although the operator obtains an economic advantage from the production of the gas through its contracts, it has no capital investment in the gas wells and is a contractual beneficiary of the extraction of gas.

11. The court further stated that the retained royalties reflect not only the value of oil and gas at the wellhead, but also the significant value that Exxon adds through transportation and processing, and do not dissolve Qatar's and Malaysia's economic interest. The court determined that the key is whether the payments depend on minerals.

12. The court differentiated these facts from cases that involve production payments, which provide a right to income for a limited time or amount. However, the court acknowledges that production payments, like traditional

royalties, can also reflect income from minerals, although it provided that when a payment can be satisfied by an alternative, nonmineral source of income, the recipient lacks an economic interest because minerals are not the sole source of recovery, resulting in sales treatment. The court determined that a taxpayer has an economic interest only if the taxpayer looks solely to the extraction of oil or gas for a return on capital, which it determined was met because Qatar and Malaysia received no guaranteed price based on Exxon's mineral extraction. The court further provided that the correct question is whether a party has a right to any income that depends solely on the extraction and sale of minerals, not whether a party is entitled to oil payments and nothing else.

13. In affirming the district court's determination that Exxon is not liable for a $200 million penalty, the Fifth Circuit relied on the district court's fact-finding during its bench trial. A penalty applies when a refund claim is for an excessive amount and there is not a reasonable basis for the claim. The Fifth Circuit stated that Exxon's position was close to the "reasonable basis" line as no case has ever held that a traditional royalty does not leave the transferor with an economic interest in the oil from which it can still profit. It is good that the Fifth Circuit rejected the government's penalty claim. The fact that no case has ever specifically addressed the narrow issue should not result in a penalty claim, as long as the position has a reasonable basis.

14. The court also addressed an excise tax question regarding an amount of excise tax Exxon can deduct from its gross income: (1) the lesser amount it actually paid after claiming a renewable-fuel credit, or (2) the greater amount it would have paid without the credit. The Fifth Circuit affirmed the District Court in deciding that Exxon's renewable-fuel credit reduced its excise tax so that it can deduct only the reduced amount.

15. Rehearing Denied. The US Court of Appeals for the Fifth Circuit on Sept. 20 denied ExxonMobil Corp.'s request for a rehearing en banc of its August 2022 ruling where it ruled that Exxon had mineral leases, not mineral sales, and denied Exxon's claim for a refund of approximately $1 billion. See our prior coverage in Neumann and Ushakova-Stein, U.S. Tax Review: IRA, Medtronic and Exxon, and Pillar 2, Volume 107, p. 1117.

B. FTC Source Case.

1. In *Aptargroup Inc.*,[3] the Tax Court held March 16 that a U.S. corporation had to use the same method in the apportionment of interest expense for foreign tax credit purposes that its CFC used in apportioning its interest expense.

2. Parent (P), a U.S. corporation, claimed an FTC under section 901. In allocating and apportioning interest expense as part of the section 904 limitation calculation, P used the asset method, under which it characterized its CFC stock. However, the CFC apportioned interest expense

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[3] *Aptargroup Inc. v. Commissioner*, 158 T.C. No. 4 (2022).

under the modified gross income method. Thus, P did not use the same method that the CFC used for interest expense apportionment.

3. To compute the FTC limitation, the taxpayer must determine the source for its gross income under the section 861 sourcing regulations. After determining the source of the gross income, the taxpayer must allocate each loss, expense, and other deduction (collectively, expenses) to a class of gross income and then, if necessary, apportion the expense within the class of gross income between (or among) a statutory grouping and a residual grouping.

4. Special rules exist for allocation and apportionment of interest expense in reg. section 1.861-9T, as effective from July 16, 2014, to December 7, 2016, which cover the years at issue.

5. Under reg. section 1.861-9T(f)(3), domestic corporations must use the asset method, but CFCs are permitted to choose either the asset method or the modified gross income method, subject to certain consistency requirements.

6. The court pointed to the relevant version of reg. section 1.861-9T(f)(3)(iv), which provided: "Pursuant to [reg. section 1.861-12T©(2)], the stock of a controlled foreign corporation shall be characterized in the hands of any United States shareholder using the same method that the controlled foreign corporation uses to apportion its interest expense." This is the consistency requirement.

7. The taxpayer argued that the reference to reg. section 1.861-12T(c)(2) in reg. section 1.861-9T(f)(3)(iv) created an exception to the consistency requirement. The Tax Court disagreed. The Tax Court did not read the reference to reg. section 1.861-12T in reg. section 1.861-9T(f)(3)(iv) as limiting the application of the consistency requirement but rather as providing supplemental rules. The court held that the consistency requirement of reg. section 1.861-9T(f)(3)(iv) does not depend on whether reg. section 1.861-12T applies.

8. The Tax Court held that P's position is inconsistent with the proper application of reg. section 1.861-9T(f)(3)(iv), which requires the U.S. shareholder of a CFC to allocate and apportion its interest expense using the same method that the CFC used to allocate and apportion its interest expense.

C. Section 965 Transition Tax Case..

1. On April 7 the Ninth Circuit in *Moore*[4] affirmed a district court's dismissal of a taxpayer's suit to invalidate the section 965 transition tax. The taxpayers challenged the constitutionality of subpart F's ability to permit taxation of a controlled foreign corporation's income after 1986 through the transition tax on the grounds that it violates the Constitution's apportionment clause and the Fifth Amendment's due process clause.

[4] *Moore v. United States*, No. 20-36122 (9th Cir. 2022).

2. Under section 965, U.S. persons owning at least 10 percent of a CFC are taxed on the CFC's profits after 1986 at a rate of either 15.5 percent for earnings held in cash or 8 percent otherwise. This tax is imposed regardless of whether the CFC distributed earnings. Section 965 also modified CFC taxes going forward: Effective January 1, 2018, a CFC's income taxable under subpart F includes current earnings from its business.

3. The district court granted the government's motion to dismiss for failure to state a claim and denied the taxpayer's cross-motion for summary judgment. It held that the transition tax taxes income and, although it is retroactive, it does not violate the apportionment clause or the due process clause.

4. The Ninth Circuit panel first held that, given the government's power under the Constitution to lay and collect taxes and adopt laws that are necessary and proper to effectuate this purpose, the transition tax is consistent with the apportionment clause. Under the apportionment clause, a direct tax must be apportioned so that each state pays in proportion to its population. However, the 16th Amendment exempts from the apportionment requirement the category of "incomes, from whatever source derived."

5. Courts have consistently upheld the constitutionality of taxes similar to the transition tax on the grounds that the realization of income does not determine the tax's constitutionality and that there is no constitutional ban on Congress disregarding the corporate form to facilitate taxation of shareholders' income. The Ninth Circuit panel explained that since subpart F only applies to U.S. persons owning at least 10 percent of a CFC, the transition tax builds upon a preexisting liability attributing a CFC's income to its shareholders, and that the taxpayers were, and continue to be, treated as individuals who have some ability to control distribution.

6. The taxpayers argued that *Macomber*[5] and *Glenshaw Glass*[6] require income to be realized before it can be taxed. However, the court stated that in *Macomber*, the Supreme Court was clear that it was only providing a definition for income, and that there was not a universal definition. The court also stated that *Glenshaw Glass* reiterated the limited scope of *Macomber*'s definition of income by emphasizing that, while the definition "served a useful purpose . . ., it was not meant to provide a touchstone to all future gross income questions." The court noted that the Supreme Court later made clear that *Macomber* and *Glenshaw Glass* do not provide a universal definition of income, and the Ninth Circuit has not adopted the taxpayer's definition of income.

7. As a result, the court found that subpart F, as modified by the transition tax, is consistent with the apportionment clause. It further stated that, although it does not control the court's analysis, a holding that subpart F is unconstitutional under the apportionment clause would also call into question

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5 *Eisner v. Macomber*, 252 U.S. 189, 219 (1920).
6 *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

the constitutionality of many other tax provisions that have long been on the books.

8. The panel also held that although retroactive legislation may violate the due process clause, the transition tax does not violate it. In its analysis, the court assumed, without deciding, that the transition tax is retroactive.

9. In its analysis, the court further stated that while there is a presumption against retroactive laws, retroactive tax legislation is often constitutional. The court looked to the deferential standard of "whether [the] retroactive application itself serves a legitimate purpose by rational means" and found that the transition tax serves a legitimate purpose: It prevents CFC shareholders that had not yet received distributions from obtaining a windfall by never having to pay taxes on their undistributed offshore earnings. Further, the court found that having a single date of repatriation is a rational administrative solution that accelerates the effective repatriation date of undistributed CFC earnings to a date following passage of the Tax Cuts and Jobs Act.

10. While the taxpayer's position had many merits, tax challenges based on constitutionality are, as a practical matter, an uphill battle. The next constitutionality challenge could come with the new corporate AMT. Stay tuned.

D. Sixth Circuit's APA Decision.

1. On March 3 the Sixth Circuit in *Mann Construction Inc.*[7] reversed a May 2021 decision by the U.S. District Court for the Eastern District of Michigan and held that the IRS did not comply with the Administrative Procedure Act (APA) when issuing Notice 2007-83, 2007-2 C.B. 960, addressing listed transactions.

2. This notice designates certain employee- benefit plans featuring cash-value life insurance policies as listed transactions. From 2013 to 2017, Mann Construction established an employee- benefit trust that paid the premiums on a cash- value life insurance policy benefiting its two founders. Neither the individuals nor the company reported this arrangement to the IRS as a listed transaction.

3. The IRS concluded that this structure fit the description identified in Notice 2007-83 and imposed penalties on the company and both of its shareholders for failure to disclose. The company and the shareholders challenged the validity of the notice and penalties on the grounds that the notice failed to comply with the notice and comment requirements of the APA; constituted unauthorized agency action; was arbitrary and capricious; and even if it were valid, the arrangement at issue did not fall within its scope.

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[7] *Mann Construction Inc. v. United States*, No. 21-1500 (2022).

4. The three-judge panel ruled in favor of the taxpayer on the first issue and did not address the remaining three issues. The court stated that before an agency may promulgate a regulation that has the force of law, it must publish a notice about the proposed rule, allow the public to comment on the rule, and, after considering the comments, make appropriate changes and include in the final rule a "concise general statement of" its contents. Courts must "set aside" agency actions that fail to follow these requirements.

5. The IRS did not follow these notice and comment procedures when it issued Notice 2007-83. It offered two explanations for declining to follow the process: Notice 2007-83 is merely an interpretive rule (which does not require notice and comment) as opposed to a legislative rule (which does require notice and comment); and, even if the notice were a legislative rule, Congress exempted the IRS from the APA's requirements regarding these disclosure rules.

6. The court stated that legislative rules have the "force and effect of law"; interpretive rules do not. It further provided that legislative rules impose new rights or duties and change the legal status of regulated parties; interpretive rules articulate what an agency thinks a statute means or remind parties of preexisting duties. When rulemaking carries out an express delegation of authority from Congress to an agency, it usually leads to legislative rules; interpretive rules merely clarify the requirements that Congress has already put in place.

7. The court ruled that this notice was a legislative rule because it has the force and effect of law. The court provides that the notice defines a set of transactions that taxpayers must report, and that duty did not arise from a statute or a notice and comment rule. Taxpayers had no obligation to provide information regarding this type of transaction before the notice. The court further states that obeying these new duties can "involve significant time and expense," and failure to comply comes with the risk of penalties and criminal sanctions, all characteristics of legislative rules.

8. The court stated that the notice also stems from an express and binding delegation of rulemaking power. Congress tasked the IRS with determining by regulations how taxpayers must make returns or statements and the information they must provide to the IRS when doing so under section 6011(a). In identifying a new type of transaction purportedly satisfying these demands, Notice 2007-83 purports to carry out this congressional delegation.

9. The IRS argued that the notice merely interprets the term "tax avoidance transaction" in section 6707A. However, the court found that the government's argument overlooks the reality that the relevant statutory terms are not self-defining. As a result, the court found that the notice is a legislative rule and is thus subject to the notice and comment requirements.

10. Importantly, the court further found that Congress did not exempt the IRS from the APA's requirements, which must be express. The court looked to the

relevant code provisions and determined that the statutes do not say anything, expressly or otherwise, that modifies the baseline procedure for rulemaking established by the APA. Congress also did not expressly displace those requirements by creating a new procedure for the regulations under the relevant code sections. The opinion also provided that legislative history standing alone cannot supply the “express,” “plain,” or “clear” direction needed to show that Congress modified the APA’s procedures in this area.

11. As a result, the court ruled that Notice 2007-83 did not satisfy the notice and comment procedures for promulgating legislative rules under the APA. The entire notice was thus invalid.

E. Invalidation of Section 245A Regulations Case.

1. A federal district court in Colorado ruled April 4 in *Liberty Global Inc.*[8] that the temporary section 245A regulations issued in 2019 (T.D. 9865), and retroactive to the application of section 245A beginning in 2018, were invalid as they did not meet the Administrative Procedure Act’s notice and comment requirements.

2. This case is important not only for the taxpayers that are affected by the 245A temporary regulations but also because it provides additional case authority that regulations, and in particular temporary regulations, must follow the requirements of the APA, including the notice and comment requirement. It will be interesting to see how this case and the other recent taxpayer-favorable APA cases, including *Mann Construction*,[9] affect not only taxpayers’ desire to challenge regulations and IRS guidance under the APA but also the IRS’s use of temporary regulations and other guidance and the timing on issuance of regulations after Congress enacts a law.

3. The final section 245A regulations issued in 2020 (T.D. 9934), which are prospective, were not at issue in the case.

4. Liberty Global Inc. (LGI) entered into a transaction in December 2018 in which one of its affiliates sold its interest in a Belgian company to LGI’s U.K. parent company, Liberty Global. LGI was required to recognize income equal to its share of gain from this transaction, and it deducted that income under section 245A. LGI argued that it met the requirements of section 245A to receive the deduction and that the temporary regulations, which precluded the deduction, were invalid and did not apply.

5. Under section 245A, domestic corporations are eligible for a dividends received deduction for dividends paid to a U.S. shareholder from a controlled foreign corporation. This section works in concert with the global intangible low-taxed income tax.

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[8] *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. 2022).
[9] *Mann Construction Inc. v. United States*, No. 21-1500 (6th Cir. 2022).

6. The effective dates for GILTI and section 245A apply differently under the Tax Cuts and Jobs Act. Section 245A was effective for distributions made after December 31, 2017. As a result, a U.S. shareholder of a non-calendar-year CFC could receive dividends and take the section 245A deduction beginning January 1, 2018. However, the GILTI rules were not effective until the CFC's first tax year beginning after December 31, 2017. Thus, for a CFC that did not have a calendar tax year, GILTI did not apply to the U.S. shareholder until the CFC's new tax year began in 2018. As a result, U.S. shareholders of non-calendar-year CFCs could take the section 245A deduction on earnings that did not result in a GILTI inclusion. This is colloquially called the "doughnut hole" period.

7. The temporary section 245A regulations had a retroactive effective date to fix the doughnut hole issue. Treasury claimed that it had the authority to issue regulations with a retroactive effective date under section 7805(b)(2) because the regulations were promulgated within 18 months of the enactment of the underlying statute.

8. LGI argued that Treasury does not have the authority to issue regulations that are contrary to the express language of the statute. The effective date is clear in the statutes, and there is no ambiguity in the language of the statute that would give Treasury gap-filling authority to promulgate regulations. LGI also argued that the temporary regulations are invalid because Treasury did not have authority to make the temporary regulations retroactive. Third, it argued that the temporary regulations are invalid because they were not promulgated in compliance with the APA's notice and comment requirements.

9. The court ruled in favor of LGI on the third argument and did not address the first two arguments. By deciding the case only on the third argument, the court avoided having to address the very important first two arguments raised by LGI. The court did not decide if Treasury could justify regulations that are contrary to the plain language of the statute by citing purpose, and the court did not decide the limits of Treasury's authority to issue retroactive regulations.

10. In ruling on the third notice and comment argument, the court addressed three issues:

    (a) whether Treasury was required to comply with APA notice and comment procedures in promulgating the temporary regulations;

    (b) whether Treasury had good cause in this instance to depart from the requirement to comply with notice and comment procedures; and

    (c) whether Treasury's failure to comply with notice and comment procedures was harmless error.

11. LGI argued that the grant of authority to issue temporary regulations in section 7805(e) does not excuse those temporary regulations from

compliance with APA procedures. The government argued that the temporary regulations were not required to comply with the APA because a more specific statute, section 7805(e), governs the regulations and contemplates the creation of immediately effective temporary rules. The government further argued that section 7805(e) would be read into a nullity if temporary regulations undergo notice and comment before promulgation.

12. LGI and the government did not dispute that the temporary regulations are legislative rules and that under normal circumstances they would be subject to the APA's notice and comment requirements. The court stated that section 7805(e) does not give a clear indication that Congress intended notice and comment procedures to not apply to temporary regulations. The court further stated that section 7805(e) does not establish procedures different from those required by the APA to indicate that Congress intended the statute to displace the APA requirements.

13. On the second issue, the court looked to the APA, which states that if the agency provides a good-cause statement of reasons that notice and comment are impracticable, unnecessary, or contrary to public interest, then the agency is not required to comply with the notice and comment procedures. Treasury stated there was good cause because:

    (a) allowing time for notice and comment would allow or even encourage taxpayers to engage in the very behavior that these regulations seek to prevent;

    (b) taxpayers would not have had sufficient time to take account of the retroactive regulations in their initial filing of tax returns and would instead have to file amended tax returns to comply with the temporary regulations, increasing taxpayer compliance costs;

    (c) the temporary regulations will only be in place for a limited amount of time, and there will be full opportunity for interested parties to comment on the final regulations; and

    (d) the final regulations' retroactivity provision ensures that the international tax regime enacted by Congress in the TCJA and its interaction with existing tax rules will function correctly for all affected periods.

14. On the first reason, the court stated that although there was reason to be concerned with taxpayers' actions, there was sufficient time to issue the temporary regulations after a notice and comment period of 18 months. On the second reason, the court stated that the potential inconvenience and cost to taxpayers of filing amended tax returns does not override the public's interest in having an opportunity to comment on proposed regulations or the public interest in taxing consistently with congressional intent.

15. In addressing the government's third reason, the court agreed with LGI that if post-promulgation notice and comment were sufficient for the good-cause exception, notice and comment would never occur before promulgation. Lastly, in addressing the fourth reason, the court stated that even if Treasury only learned of transactions like the one at issue in October 2018, that left roughly seven months to complete the 30-day notice and comment period and receive retroactivity under section 7805(b)(2). The court further stated that if the deadline could not have been met because an opportunity for notice and comment had been given, and retroactivity would thereby have been lost, it would have found that to be good cause. However, the court determined that this was not shown.

16. On the harmless error issue, LGI argued that post-promulgation notice and comment does not alleviate the harm because the final regulations, unlike the temporary regulations, were not retroactive, so it had no opportunity to comment on whether retroactivity was appropriate. The court agreed that the error was not harmless. Harmless error is only applicable in review of agency action "when a mistake of the administrative body is one that clearly had no bearing on the procedure used or the substance of decision reached."

17. As a result, the court held that the retroactive temporary section 245A regulations did not meet the APA's notice and comment requirements and were thus invalid.

F. *Jarrett v. United States*.

1. Jarrett is a district court case in which individual taxpayer is arguing that creation of tokens through staking are not income when first created by the taxpayer, but rather when such tokens are sold or exchanged. The case is one of first impression.

2. The IRS proffered a refund to the taxpayer, which the taxpayer rejected. The government moved to dismiss the case, and the taxpayer challenged the government's motion. The district court rejected the taxpayer's challenge. The deadline for filing an appeal is at the end of this month.

3. The procedural aspect of this case is important whenever there is a tax issue that is capable of repetition but, due to the IRS proffer of a refund, evades judicial review.

4. Particularly noteworthy here, the government denied that its offer of a refund is an admission of liability or binds the IRS to do anything in the future.

VI. TRANSFER PRICING DEVELOPMENTS.

A. Stock Based Compensation Rulings.

1. The IRS released two new cost-sharing arrangement (CSA) stock-based compensation (SBC) private letter rulings, LTR 202227006 and LTR

202227007. Both rulings allowed the taxpayer to change their method for measuring SBC that must be included as CSA intangible development costs (IDCs).

2. In LTR 202227006 (dated April 12), at the time of entering into the CSA, the U.S. company was a private company and was required to use the default method for the measurement and timing of SBC provided in reg. section 1.482-7(d)(3)(iii)(A) and the grant date identification method in reg. section 1.482-7(d)(3)(ii). The private company was then acquired by a public domestic corporation.

3. Reg. section 1.482-7(d)(3)(iii)(B)(1) provides an alternative elective method for measurement and timing of SBC IDCs with respect to options on publicly traded stock, which was extended to certain restricted shares and restricted share units by Notice 2005-99, 2005-2 C.B. 1214.

4. The taxpayer requested consent to prospectively change the method for measuring and timing of SBC costs that must be included as IDCs from the default method to the method described in reg. section 1.482-7(d)(3)(iii)(B).

5. The taxpayer also requested consent to prospectively change the method for identifying SBC costs with the intangible development activity from grant date identification as provided in reg. section 1.482-7(d)(3)(ii) to the period-by-period identification as provided in Notice 2005-99.

6. The IRS granted prospective consent to change to the elective method and period-by-period identification provided the election is made within 60 days of the date of the letter ruling.

7. LTR 20227007 (dated April 12) is similar.

8. It is not clear whether the taxpayer was within the jurisdiction of the Ninth Circuit, which reversed a unanimous Tax Court in *Altera v. Commissioner*, and held that regulations requiring the inclusion of SBC in IDCs were valid. Taxpayers outside the Ninth Circuit are not subject to the *Altera* decision, and it is arguable whether taxpayers within the Ninth Circuit are subject to *Altera* if an income tax treaty applies.

B. <u>Eaton's APA Case</u>.

1. <u>Overview</u>.

(a) In *Eaton*,[10] the Sixth Circuit upheld the Tax Court's decision[11] and sided with Eaton on all issues relating to Eaton's advance pricing agreements.

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[10] *Eaton Corp. v. Commissioner*, Nos. 21-1569 and 21-2674 (6th Cir. 2022).

[11] *Eaton v. Commissioner*, T.C. Memo. 2017-147.

(b) The government appealed the Tax Court's 2017 decision in favor of Eaton asserting that the IRS did not abuse its discretion in retroactively canceling two APAs. The appeal also challenged the 2019 Tax Court decision that Eaton was not liable for transfer pricing penalties under section 6662.[12]

(c) The IRS claimed that Eaton did not comply in good faith with the terms and conditions of the APA and that Eaton failed to satisfy the APA annual reporting requirements. The two APAs involved the best method for determining the arm's-length prices for the sale of products from manufacturing operations in Puerto Rico within the United States and the Dominican Republic into the United States. The first APA covered 2001 through 2005; the second covered 2006 through 2010. The IRS canceled both APAs retroactively in 2011.

(d) In our view, the IRS's retroactive cancellation of the APAs could undermine the purpose of APAs. We therefore applaud the Sixth Circuit upholding the Tax Court's decision.

(e) The Tax Court held that canceling an APA is a rare occurrence and should be done only in cases in which there are valid reasons consistent with the relevant revenue procedures. A misrepresentation must be false or misleading, usually with the intent to deceive, and must relate to the terms of the APA. Analyzing *Eaton*'s facts, the Tax Court stated that the IRS's different viewpoint is not the same as a misrepresentation and is not grounds for terminating an APA. The court said an APA is a binding agreement and should not be canceled because of a desire to change the underlying methodology of a transfer pricing method.

2. Sixth Circuit's Analysis.

(a) The Sixth Circuit reviewed the Tax Court's interpretation and application of law *de novo* and its factual findings for clear error. The threshold question is burden of proof. The Sixth Circuit stated that the IRS has the burden and that it attempts to hide behind administrative deference to avoid the consequences of its bargain. The Sixth Circuit looked to contract law and Eaton's conduct under the contract (the APA). The Sixth Circuit's opinion stated that the tax collector is not above the law and that this case arises from the IRS's efforts to circumvent basic contract law. The Sixth Circuit noted that none of the cases cited by the IRS involve contracts.

(b) The court noted that the government has broad discretion to enter into contracts, but "once it enters into a contract, the government must play by the rules like everyone else." The Sixth Circuit stated that "it makes little sense that a sophisticated party like Eaton would expend

[12] *See Eaton v. Commissioner*, 153 T.C. No. 6 (2019).

years negotiating over the minutiae of its convoluted bargain, only to leave so much in the hands of the government." The opinion stated that the revenue procedures (Rev. Proc. 2004-40, 2004-2 C.B. 50; and Rev. Proc. 96-53, 1996-2 C.B. 375) never reserved discretion for the IRS and, to the contrary, state that an APA is a binding agreement. The IRS in its revenue procedures could have specified a different burden in the APAs that was more pro-government, but it did not.

(c) Once the court determined that contract law applied, it then looked to whether the IRS established grounds to cancel the APAs, basically requiring the IRS to prove that Eaton's conduct broke the terms of the APA contract. The IRS argued that it was permitted to cancel the APA because of Eaton's alleged failure to disclose some facts, its calculation errors, and its representations in the annual reports. Under Rev. Proc. 2004-40, the IRS "may cancel" an APA for "the failure of a critical assumption," "the taxpayer's misrepresentation, mistake as to a material fact, failure to state a material fact, failure to file a timely annual report, or lack of good faith compliance with the terms and conditions of the APA." The Sixth Circuit stated that the "IRS's arguments miss the mark."

(d) The revenue procedures provide an exhaustive list of reasons for cancellation of an APA, but the IRS urged the court to look beyond the cancellation section in the revenue procedures. The court refused. The IRS may only cancel an APA according to the conditions for cancellation under Rev. Proc. 2004-40, section 10.06(1); see also Rev. Proc. 96-53, section 11.06(1). The key analysis is whether Eaton's conduct materially complied with the terms of the APA contract. The court analyzed all the reasons provided by the IRS and determined it did not meet its burden in proving that Eaton's conduct was not in material compliance with the APA terms.

3. Penalty Analysis.

(a) The court then turned to the penalty issue. Eighteen months after the trial, the IRS asserted penalties of 40 percent under 26 U.S.C. section 6662(h). This occurred after the Tax Court issued its principal opinion (finding that the IRS wrongfully canceled the APAs). Eaton originally argued that the IRS forfeited its penalty claim by failing to raise it at or before trial and failing to get written approval. Eaton also argued that its corrections could not trigger penalties because they did not constitute section 482 adjustments as a threshold matter. The district court avoided the first two arguments and ruled in favor of Eaton on the section 482 argument.

(b) In the Sixth Circuit, Eaton conceded that its self-corrections were section 482 adjustments but sought affirmance on the forfeiture and written approval grounds. The Sixth Circuit affirmed on the

penalties question, without adopting the Tax Court's reasoning. The Sixth Circuit ruled in favor of Eaton on the forfeiture claim and did not address the written approval claim.

(c) The Sixth Circuit found that penalties may only be imposed if they are asserted before the hearing or a rehearing in Tax Court under section 6214(a). The Sixth Circuit found that the adjustments that gave rise to the post-trial penalties claim were not placed in issue by the pleadings, addressed as an issue at trial, or discussed by the Tax Court in its prior opinion and, as a result, held that the IRS forfeited the penalties claim. This is important**;** it would be inappropriate if the IRS could assert penalties after the trial.

4. Rev. Proc. 99-32 Analysis.

(a) The final issue was whether Eaton was entitled to relief from double taxation under Rev. Proc. 99-32. Eaton's corrections resulted in the overseas subsidiaries having extra cash that they needed to repatriate. Rev. Proc. 99-32 solves that problem by treating the original overpayment as a loan or advance and the repatriation of the excess cash as repayment of a loan, not taxable income.

(b) The Tax Court denied Rev. Prov. 99-32 relief because it only applies to section 482 adjustments and held that Eaton's self-corrections did not constitute section 482 adjustments. With Eaton conceding that its self-corrections were section 482 adjustments, the Sixth Circuit held that double taxation relief under Rev. Proc. 99-32 was allowed. The Sixth Circuit remanded the case to the Tax Court so that the IRS could enter into a stipulation with Eaton regarding the conforming adjustments under Rev. Proc. 99-32.

C. *Medtronic* Transfer Pricing Method Case.

1. Overview.

(a) In an interesting turn of events, the Tax Court in *Medtronic* (*Medtronic II*) revised its earlier opinion and used a new unspecified transfer pricing method.[13] The new transfer pricing method significantly increased the royalty rate paid to the United States.

(b) The Eighth Circuit[14] had vacated the Tax Court's[15] earlier decision (*Medtronic I*) and had remanded the case to the Tax Court for a comparability assessment.

(c) Medtronic used the comparable uncontrolled transaction transfer pricing method to determine the royalty rate for the intangibles owned

[13] *Medtronic v. Commissioner*, T.C. Memo. 2022-84.
[14] *Medtronic v. Commissioner*, 900 F.3d 610 (8th Cir. 2018).
[15] *Medtronic Inc. v. Commissioner*, T.C. Memo. 2016-112.

in the United States and licensed to the Puerto Rican manufacturing subsidiary (MPROC). The IRS rejected Medtronic's CUT method, even though it had previously agreed to it in a memorandum of understanding. The IRS asserted that the comparable profits method was the best method.

2. *Medtronic I*.

(a) In *Medtronic I*, the Tax Court found that the CPM downplayed MPROC's role in ensuring quality, that it used an incorrect return on assets approach, that it improperly aggregated the transactions, and that it ignored the value of licensed intangibles. The Tax Court engaged in its own valuation analysis and decided that Medtronic's CUT method was the best way to determine an arm's-length royalty rate for intercompany agreements but made several adjustments.

(b) The Tax Court in *Medtronic I* applied the company's Pacesetter CUT. The Pacesetter CUT was entered into by Medtronic with Pacesetter to settle several lawsuits regarding patent and license use. The Tax Court determined that the Pacesetter agreement was an appropriate CUT because it involved similar intangible property and had similar circumstances regarding licensing.

(c) The Eighth Circuit remanded the Medtronic I case to the Tax Court and stated that the Tax Court did not address in sufficient detail whether the Pacesetter CUT was comparable and created in the ordinary course of business (since it was part of a litigation settlement). Also, it stated that the Tax Court did not analyze the degree of comparability.

3. *Medtronic II*.

(a) The *Medtronic II* Tax Court opinion starts with an overview of the positions and provides a detailed overview of the applicable section 482 statute and regulations. The opinion describes the four different pricing methods in the regulations: the CUT method, the CPM, the profit-split method, and unspecified methods. The opinion also describes the commensurate-with-income (CIW) statute, regulations, legislative history, and caselaw, and states that the CIW standard works consistently with the arm's-length standard.

(b) In determining whether the Pacesetter agreement is an appropriate CUT, the *Medtronic II* Tax Court opinion performed a detailed review of the comparability factors in reg. section 1.482-1(d)(1). The five general comparability factors are (1) functions, (2) contractual terms, (3) risks, (4) economic conditions, and (5) property or services.

(c) In terms of functions, the Tax Court concluded MPROC was engaged in finished manufacturing of Class III medical devices, and that this differs from the Pacesetter agreement because Pacesetter also performed research and development, component manufacturing, and distribution. Therefore, the Tax Court concluded that MPROC and Pacesetter did not perform the same functions.

(d) When looking at economic conditions, the Tax Court concluded that the economic conditions were not comparable because of the difference in profit potential. MPROC had a profit margin of 54 percent, and Pacesetter only has a product profit margin of 29 percent. The Tax Court disagreed with the government's position that a vertical relationship cannot be compared with a horizontal relationship. The Pacesetter agreement was a "horizontal" relationship because the agreement is between competitors. The MPROC license has a "vertical" relationship because the agreement is between a corporation and a controlled subsidiary. The Tax Court stressed that the transfer pricing regulations do not require that both transactions compared have a vertical or horizontal relationship.

(e) The intangible property licenses under the MPROC agreement included secret processes, technical information, technical expertise, and all legal rights including know-how. The total number of patents available to MPROC under the licenses reached 1,800 in 2006, whereas the Pacesetter agreement licensed 342 patents. Accordingly, the Tax Court concluded that the products licensed were not similar.

(f) Since three of the five general comparability factors were not met, the Tax Court concluded that the Pacesetter agreement and the MPROC licenses do not meet the general comparability factor requirements.

(g) The Tax Court then analyzed whether appropriate adjustments could be made to the Pacesetter agreement. In light of the Eighth Circuit's mandate, the Tax Court reviewed its initial adjustments and concluded that too many adjustments were required to the Pacesetter CUT. As a result, it concluded that the CUT was not the best method and that the outcome in *Medtronic I* should be changed.

(h) The Tax Court concluded that the Pacesetter agreement was reached in the ordinary course of business even though it was part of a litigation settlement.

(i) The Tax Court held that even though there are enough differences between the Pacesetter agreement and MPROC licenses to conclude that the Pacesetter agreement was not a CUT; there are enough similarities that the Tax Court used the Pacesetter agreement as a starting point for determining the proper royalty rate.

(j) The Tax Court disagreed with the government's argument that MPROC was a routine manufacturer of finished products, like in *Coca-Cola*.[16] The government's CPM method used routine manufacturing comparables, and MPROC employed a highly trained workforce that was ultimately responsible for inspecting finished devices and ensuring that they functioned properly. MPROC could not be easily replaced. The Tax Court stated the CPM method by the government was an abuse of discretion because of the use of flawed comparables.

(k) Similar to the conclusion in *Medtronic I*, the Tax Court in *Medtronic II* determined that an unspecified method was the best method. However, based on the expert testimony from the further trial, the Tax Court in *Medtronic II* concluded that the royalty rate in *Medtronic I* was too low to adequately account for the difference in profit potential between MPROC and the Pacesetter agreement.

(l) The unspecified method in *Medtronic II* combines aspects of both the CUT and the CPM in a three-step process. The first step uses the CUT method to reach a royalty rate of 8 percent for the trademark license. Step two then applies the CPM method to allocate profit to MPROC's activities. The third step allocates the remaining profit between Medtronic US (80 percent) and MPROC (20 percent) under a profit-split approach. Changing the remaining allocation in step three to an 80-20 profit split results in a wholesale royalty rate of 48.8 percent. The wholesale royalty rate of 48.8 percent results in an overall profit split of 68.72 percent to Medtronic US and 31.28 percent to MPROC and an R&D profit split of 62.34 percent to Medtronic US and 37.66 percent to MPROC. The Tax Court states that the resulting profit split reflects the importance of the patents as well as the role played by MPROC.

(m) The Tax Court basically split the baby with a profit-split method. The Tax Court noted that the wholesale royalty rate of 48.8 percent significantly bridges the gap between the parties. Medtronic proposed a CUT that resulted in a blended wholesale royalty rate of 21.8 percent; whereas the government's CPM analysis resulted in a blended wholesale royalty rate of 67.7 percent. In *Medtronic I*, the Tax Court concluded that the blended wholesale royalty rate was 38 percent. In *Medtronic II*, the Tax Court made profit-split adjustments that increased the wholesale royalty rate by an additional 4.8 percent to 48.8 percent.

[16] *Coca-Cola Co. v. Commissioner*, 155 T.C. 145 at 217-218 (2020).

VII. IRS RULINGS.

A. Transition Tax Legal Memo.

1. On August 2 the IRS released a legal memorandum (ILM 202235009) concluding that a failure to report section 965 transition tax liability while still disclosing the position to challenge the final regulations is considered a deficiency because of negligence or intentional disregard and thus the liability may not be prorated over eight years under section 965(h)(4).

2. The IRS stated that filing a Form 8275-R, regulation disclosure statement, or other disclosure of a taxpayer's position is not relevant because section 965(h)(4) and reg. section 1.965-7(b)(1)(ii)(C) do not provide an exception in cases of disclosure of a disregarded rule.

3. In the legal memorandum, a domestic corporation filed Form 1120, "U.S. Corporation Income Tax Return," for its 2018 tax year, which included a statement electing to pay the section 965(h) net tax liability in eight installments under section 965(h)(1). The domestic corporation's return position did not reflect application of the final regulations. The IRS determined a deficiency in the domestic corporation's tax resulting from the domestic corporation's position being contrary to the final regulations.

4. Section 965(h)(4) provides that if an election is made under section 965(h)(1) to pay the net tax liability under section 965 in installments and a deficiency has been assessed on the net tax liability, the deficiency is prorated to the installments payable under section 965(h)(1). Section 965(h)(4) states that the election to pay the net tax liability under section 965 in installments does not apply if the deficiency is because of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. As provided in reg. section 1.965-7(b)(1)(ii)(C), if a deficiency or additional liability is because of negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, the proration rule will not apply, and the deficiency or additional liability, as well as any applicable interest and penalties, must be paid on notice and demand by the IRS, or in the case of an additional liability, reported on a return increasing the amount of the section 965(h) net tax liability after payment of the first installment or on an amended return, with the filing of the return.

5. The legal memorandum concluded that under section 965(h)(4), the domestic corporation is not entitled to prorate the deficiency, and the deficiency is due on notice and demand under section 965(h)(4) and reg. section 1.965-7(b)(1)(ii)(C).

B. IRM Guidance on Section 965.

1. On Sept. 21, the IRS Large Business and International Division issued guidance, LB&I-04-0922-0019, to its employees regarding the section 965(k) six-year statute of limitations on assessment for returns with a section 965

transition tax. This guidance updates Interim Guidance Memorandum LB&I-04-1120-0020 and is intended to be incorporated into I.R.M. 4.46.5. This guidance does not cover returns subject to the centralized partnership audit regime under Bipartisan Budget Act of 2015 (BBA) or TEFRA partnerships as separate guidance was issued for these items.

2. This guidance provides that if a case is nearing the section 6501(a) three-year statute of limitations date and the taxpayer will not sign a statute extension, the examiner and manager will need to determine if a statutory notice of deficiency should be issued. If a statutory notice of deficiency is not issued before the IRC 6501(a) statute of limitations expires, there may be restrictions on the items that may be adjusted unless there is a different statute of limitations keeping the assessment open. IRC 965(k) provides a six-year statute on assessment only for the IRC 965 net tax liability, while IRC 6501(e)(1)(C) provides a six-year statute on assessment for the entire return. IRC 965(k) generally provides that the statute of limitations on assessment will not expire before six-years after the return for the inclusion year is filed. The IRC 965(k) six-year period of limitations applies only to assessment of the IRC 965 net tax liability, the calculation of which includes (but is not limited to) the IRC 965(a) inclusion and IRC 965(c) deduction. An election under IRC 965(h) allows a taxpayer to pay the IRC 965(h) net tax liability in installments over an eight-year period. The amounts deferred under IRC 965(h) are for the original year of inclusion, not the year of payment, and accordingly the IRC 965(k) period of limitations only applies to the IRC 965 inclusion year. Therefore, the IRC 965(k) six-year period of limitations on assessment is irrelevant to the assessment of tax in the later years of the deferred payments.

3. IRM 25.6.23.5.7.2 and Exhibit 25.6.23-3 provide the authority for a team manager to allow the IRC 6501(a) assessment statute to expire, unless it is a joint investigation situation. If additional examination activity relating to IRC section 965 is warranted, the IRC 6501(a) statute of limitations or extended assessment period (if ending with the IRC 965(k) six-year period) may be allowed to expire, but certain approvals and documentation must be made.

C. Section 245A IRS Ruling.

1. On July 1 the IRS released LTR 202226009, which grants a U.S. multinational section 9100 relief for an extension to file elections and agreements under reg. section 1.245A-5(e)(3)(i) to close the tax year of its CFCs.

2. In the ruling, the U.S. parent corporation treated an upper-tier CFC as receiving, or being deemed to receive, a dividend for its CFCs' stock. Reg. section 1.245A-5(e)(3)(i)(A) provides that for a tax year of a CFC in which an extraordinary reduction occurs for a controlling section 245A shareholder, no amount is considered an extraordinary reduction amount or tiered extraordinary reduction amount for the controlling section 245A shareholder if each controlling section 245A shareholder elects, and each U.S. tax resident

agrees, to close the CFC's tax year as of the end of the date on which the extraordinary reduction occurs. The U.S. parent corporation determined that, if an election under reg. section 1.245A-5(e)(3)(i) is not made, there would be an extraordinary reduction for the indirect ownership of the CFCs' stock, and a tiered extraordinary reduction amount for dividends received by an upper-tier CFC that are attributable to the stock of each of the lower-tier CFCs.

3. Reg. section 1.245A-5(e)(3)(i)(C)(1) provides that an election under reg. section 1.245A-5(e)(3)(i) is made and effective if the statement described in reg. section 1.245A-5(e)(3)(i)(D) is timely filed (including extensions) by each controlling section 245A shareholder making the election with its original U.S. tax return for the tax year in which the extraordinary reduction occurs. Reg. section 1.245A-5(e)(3)(i)(C)(2) provides that, before the filing of this statement, each controlling section 245A shareholder must enter into a written, binding agreement with each U.S. tax resident that owns directly or indirectly stock of the CFC and is a U.S. shareholder of the CFC. The written, binding agreement must provide that each controlling section 245A shareholder will elect to close the tax year of the CFC.

4. The U.S. parent corporation timely filed the consolidated tax return for its group and consistently reported the close of year election under reg. section 1.245A-5(e)(3)(i) for each of the CFCs. However, it failed to attach the required reg. section 1.245A-5(e)(3)(i)(D) election statement to the return, and the reg. section 1.245A-5(e)(3)(i)(C)(2) binding agreement was not executed.

5. Reg. section 301.9100-1(c) provides that the IRS commissioner may grant a reasonable extension of time to make a regulatory election or a statutory election. Reg. section 301.9100-3(a) provides that requests for relief will be granted when the taxpayer provides the evidence to establish to the satisfaction of the commissioner that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government.

6. The commissioner concluded that the section 9100 requirements were satisfied and granted an extension of 90 days from the letter ruling date to file elections and agreements under reg. section 1.245A-5(e)(3)(i) to close the tax year of each CFC.

D. Section 367(d) Advance Payments Not Permitted.

1. IRS Chief Counsel Memo AM 2022-003 was released September 23, providing that taxpayers may not choose to make advance payments of annual inclusions under section 367(d)(2)(A)(ii)(I), except in limited circumstances.

2. Section 367(d)(1) provides that, except as provided in regulations, if a U.S. person transfers any intangible property to a foreign corporation in an exchange described in section 351 or 361, section 367(d) (and not section 367(a)) applies to the transfer. Section 367(d)(2)(A) states that a U.S.

transferor is treated as having sold the intangible property in exchange for payments that are contingent upon the productivity, use, or disposition of the intangible property. Under section 367(d)(2)(A)(ii)(I), the U.S. transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received annually over the useful life of the intangible property. A U.S. transferor takes an annual section 367(d) inclusion into account regardless of whether the payments are actually made by the transferee foreign corporation. When a U.S. transferor takes an annual section 367(d) inclusion into account, but that amount is not actually paid by the transferee foreign corporation during the year, the section 367(d) regulations allow a U.S. transferor to establish an account receivable from the transferee foreign corporation equal to the amount deemed paid, but that was not actually paid.

3. Section 367(d) does not apply to an actual sale or license of intangible property.

4. In the memo, a domestic corporation transferred intangible property to a wholly owned foreign corporation in a section 351 transaction, making section 367(d) applicable. As a result, the domestic corporation had annual inclusions under section 367(d)(2)(A)(ii)(I) and Treas. Reg. §1.367(d)-1T(c)(1). The domestic corporation established a separate account receivable for these inclusions for each year pursuant to Treas. Reg. §1.367(d)-1T(g)(1)(i). However, the foreign corporation made a prepayment of the section 367(d) inclusions to accelerate the inclusions, rather than take each inclusion into account annually.

5. The IRS states that by turning off the application of section 367(a), the section 367(d) annual inclusion regime reflects a Congressional preference against providing immediate gain recognition with respect to intangible property.

6. The IRS notes that it has issued Notice 2012-39 regarding a section 361 exchange with boot and Chief Counsel Advice 200610019 regarding a section 351 exchange with boot and that both treated the boot as an advance payment of annual section 367(d) inclusions. However, in the recent CCM the IRS states that these are special limited circumstances, and that the IRS has not generally addressed the treatment of advance payments under section 367(d).

7. In analyzing how to treat the prepayments, the IRS determined that there are significant differences between licensing arrangements and section 367(d), thus, whether advance payments are given effect under U.S. income tax law for a licensing arrangement is irrelevant in determining whether advance payments are permitted for annual section 367(d) inclusions. In this determination, the IRS analyzed that section 367(d) may be viewed as resembling a contingent sale in certain respects – that is, a sale in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale occurs. Alternatively, the IRS reasoned that even if an outbound transfer of intangible property subject to section 367(d) is viewed as

resembling a licensing arrangement in certain respects, the 367(d) exchange involves a deemed payor that actually owns the intangible property.

8. The memo concludes that the only basis for permitting an advance payment of annual section 367(d) inclusions is under section 367(d) and the section 367(d) regulations. However, neither section 367(d) nor the section 367(d) regulations address advance payments. Thus, the IRS does not see a basis in section 367(d) or the regulations for accelerating the annual section 367(d) inclusions, and only after an annual section 367(d) inclusion is taken into account by a U.S. transferor may a transferee foreign corporation make a payment to the U.S. transferor corresponding to that deemed inclusion (through the accounts receivable construct).

9. Therefore, the IRS determined that, because the prepayment occurs after the initial section 367(d) exchange, any prepayment that does not correspond with an established account receivable is not treated as a section 367(d) inclusion and must be analyzed under general tax principles (here, a distribution by the foreign corporation on its stock).

E. <u>FDII Guidance on Deferred Compensation</u>.

1. On May 6 the IRS released a new generic legal advice memorandum (AM 2022-001) addressing the allocation and apportionment of deferred compensation expense (DCE) and concluded that the deduction relates to the year of the expense accrual. Thus, DCE relating to pre-Tax Cuts and Jobs Act years but not deducted until post-TCJA years is allocable to foreign-derived deduction eligible income (FDDEI) earned in the post-TCJA years.

2. The memorandum is directly at odds with AM 2009-001, in which the IRS held that deferred compensation earned in pre-section 199 years but deducted in section 199 years was not allocable to qualified production activities income. Footnote 1 states that AM 2009-001 “does not represent the position of the Office [of Associate Chief Counsel (International)] and is obsolete.” Further, the May memorandum applies this analysis to 2018 as the year at issue, thus indicating that the IRS will be applying the new approach retroactively.

3. The new IRS memorandum states that expense must be allocated and apportioned based upon the groupings that exist in the year the deductions are taken into account rather than looking to the income derived in the prior year to which the expense relates.

4. In the facts of the memorandum, Corporation X is an accrual-basis taxpayer with a calendar tax year that sells products to both related and unrelated distributors. Corporation X claimed the foreign-derived intangible income deduction, and the majority of its income in that year was deduction-eligible income (DEI), with a significant portion as FDDEI.

5. Corporation X had restricted stock units that created a DCE. Corporation X claimed that the DCE related to the performance of services before 2018 (the effective date of FDII) so it should be apportioned to the residual grouping and thus did not reduce gross DEI or FDDEI but did reduce other gross income in the 2018 residual grouping.

6. A deduction is allocated to a class of gross income and then, if necessary, apportioned between the statutory and residual groupings of gross income within that class under reg. section 1.861-8(a)(2). The allocation and apportionment of a deduction is based on the factual relationship of the deduction to a class of gross income. Under section 861, Corporation X must determine the factual relationship between the DCE and its gross income. A taxpayer may apportion the deduction using various bases and factors provided the method or basis "reflects to a reasonably close extent the factual relationship between the deduction and grouping of gross income."

7. The memorandum states that the statutory provisions frequently use the term "properly allocable," which some cases have interpreted but did not offer guidance in determining how that standard should be applied in the context of section 250. While it is obvious that no court previously addressed this exact FDII issue, it is questionable of the IRS to disregard all relevant case law.

8. In defending its new approach, the IRS states that although the section 861 regulations envision that a deduction may be factually related to a class of gross income even though no gross income is recognized in the current tax year, they do not change the tax year in which an expense accrues. The memorandum argues that sections 83(h), 441, 461, 861, and 862 do not contemplate that an expense, such as Corporation X's DCE, may be accrued in a different tax year than that provided under generally applicable tax accounting rules, and that sections 441 and 461 provide no support under the properly allocable standard for accruing expenses in an earlier tax year.

9. The IRS memorandum states that no authority suggests that an otherwise apportionable deduction for a tax year may be allocated to a particular grouping based on law applicable in a prior period or apportioned taking into account such prior period law.

10. It concludes that, because the class of gross income comprises DEI and FDDEI in the year in which the DCE is accrued, the deductions must be apportioned between those groupings of income. The IRS argues that the taxpayer's claim that the DCE expense may be allocated solely against residual income rather than apportioned is in effect attempting to apply the federal income tax law of an earlier period to such expense, with resulting distortion of the amount of FDDEI.

11. The IRS also argues that in other specialized contexts, the expense allocation and apportionment rules allocate and apportion expenses based upon current-year sales notwithstanding a factual connection to a different period. For this argument, the IRS memorandum cites the research and experimentation

expenditure rules and a rule adopted in 2020 that requires damages payments to be apportioned among statutory and residual groupings based on the relative amounts of gross income or relative asset values in each grouping in the tax year the deductions are allowed.

F. Inversion IRS Ruling.

1. On September 16, Private Letter Ruling 202237005 was released that addresses expatriated entities and their foreign parents under section 7474. Specifically, it addresses the determination of the ownership fraction under section 7874(a)(2)(B)(ii). The ruling was sought to determine the application of section 7874(c)(5) to certain foreign partnerships and a domestic partnership that are under common control.

2. Under section 7874(a), an expatriated entity surrogate foreign corporation has certain gain included as taxable income. There is a surrogate foreign corporation if, among other requirements, after the acquisition at least 60 percent of the stock of the entity is held by former shareholders of the domestic corporation or former partners of the domestic partnership under section 7874(a)(2)(B)(ii). Under section 7874(c)(5), in an acquisition of a domestic partnership's business, all partnerships which are under common control (within the meaning of section 482) are treated as one partnership.

3. In this ruling, individual partners and foreign founders together owned all of the interests in FP1 and FP2, each a foreign entity treated as a partnership for federal income tax purposes. FP2, in turn, owned certain interests in FP3, also a foreign entity treated as a partnership for federal income tax purposes.

4. The partners and foreign founders also together indirectly owned a certain percentage of the interests in DP, a domestic limited liability company treated as a partnership for federal income tax purposes, and FP1 owns the remaining percentage. DP, FP1, FP2, and FP3 are each under common control as that term is described in section 7874(c)(5).

5. One of the foreign founders formed New Foreign Holdco, a foreign country entity which made its initial entity classification election to be disregarded for federal income tax purposes. FP1 formed a US blocker corporation. The partners and foreign founders indirectly transferred all of the properties of FP2 and FP3 to FP1. Then FP1 contributed its interests in DP to the US blocker in exchange for stock of the blocker.

6. Subsequently, one of the investors transferred cash to New Foreign Holdco in exchange for interests in New Foreign Holdco. And then the foreign founders and partners transferred their interests in FP1 to New Foreign Holdco, in exchange for interests in New Foreign Holdco and cash. New Foreign Holdco will make an entity classification election to be a corporation for federal income tax purposes, resulting in an acquisition by New Foreign Holdco of substantially all of the properties constituting a trade or business of

a domestic partnership for purposes of section 7874(a)(2)(B) for the properties constituting a trade or business of DP.

7. A ruling was sought to provide that the application of section 7874(c)(5) and the regulations under section 7874 do not result in FP1, FP2, FP3 and DP being treated as one domestic partnership for purposes of determining the ownership fraction under section 7874(a)(2)(B) as a result of the proposed transaction. The IRS ruled that the stock of New Foreign Holdco held by reason of holding an interest in a domestic partnership, taking into account section 7874(c)(5) and the regulations under 7874, including Treas. Reg. 1.7874-2(f), includes a proportion of the stock held by reason of holding an interest in FP1 determined based on FP1's indirectly held interest in DP relative to FP1's interests in all its properties (including such indirectly held interest in DP), and does not otherwise include stock held by reason of directly or indirectly holding an interest in FP1, FP2, or FP3.

G. Foreign Currency Hedge Ruling.

1. In LTR 202152012, the Service permitted a corporation to apply the principles of Treas. Reg. § 1.988-5(b) to hedges of potential foreign currency exposure related to a proposed acquisition of a foreign company.

2. A U.S domestic corporation, through a domestic subsidiary (Acquirer), acquired a foreign target (Target) that had a different functional currency from the domestic acquirer (Currency A). Certain employees of Target have stock options that vest and become exercisable on closing. There were two different methods by which the Target employees' options could be exercised and exchanged for merger consideration, which was to consist of a mix of cash and the domestic parent's stock.

3. Target had foreign currency exposure as a result of the acquisition because the cash consideration was required to be paid in Currency A. Target purchased Currency A and Currency A derivatives to hedge its Currency A exposure relative to the USD up to the Maximum Cash Amount. The "Maximum Cash Amount" is, in general, the total Cash Consideration that Acquirer would be required to pay for all outstanding Target shares.

4. Acquirer will enter into hedges that it will identify as a hedge of the anticipated acquisition of Target shares that might be acquired for cash up to the maximum amount of cash that potentially could be paid. The hedges will satisfy the requirements of Treas. Reg. § 1.988-5(b). If all or a portion of the hedges are determined to be unneeded, the unneeded hedges will be sold or terminated.

5. Treas. Reg. § 1.988-5(b) provides that a taxpayer may integrate a hedged executory contract. Treas. Reg. § 1.988-5(e) provides that the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure.

6. The Service stated that the acquisition of Target shares is not an executory contract as defined in Treas. Reg. § 1.988-5(b)(2)(ii) and therefore there is no executory contract at the time the hedging transactions are entered into which would qualify for integrated hedging treatment under Treas. Reg. § 1.988-5(b). Thus, absent an advance ruling to the contrary under Treas. Reg. § 1.988-5(e), Acquirer is required to treat the hedges as separate section 988 transactions that are not integrated with the anticipated acquisition of Target.

7. However, here, the Service ruled that Subsidiary should be allowed to generally apply the principles of Treas. Reg. § 1.988-5(b) to integrate its hedges of underlying foreign currency exposure with respect to its anticipated Target Share Acquisition. Certain qualifications were applicable, including that for any unneeded hedge amounts Subsidiary will dispose of (or treat as sold for fair market value) the hedges in an amount equal to such amount on the day it is determined that there is an unneeded hedge.

VIII. OECD'S CRYPTO ASSET REPORTING FRAMEWORK.

A. On October 10, 2022, the Organisation for Economic Co-operation and Development ("OECD") published the Crypto-Asset Reporting Framework ("CARF"). CARF builds off of the existing Common Reporting Standard ("CRS") regime, which CARF acknowledges does not extend to most crypto assets. If and when implemented by member states, CARF will provide for the automatic exchange of tax information with respect to transactions in crypto-assets in a standardized manner across jurisdictions.

B. CARF is intended to be a turnkey solution that allows countries to easily implement crypto-reporting standards into local law. As we discuss further below, entities subject to CARF must collect data on their users and report such data to the relevant governmental authorities. Jurisdictions are able to share such information with other implementing jurisdictions with respect to entities subject to CARF and that have a relevant nexus to that jurisdiction (such as being a tax resident, incorporated, managed from, having a regular place of business, or effectuating relevant transactions through a branch in such jurisdiction).

C. CARF requires reporting on transactions involving "Relevant Crypto-Assets" which includes most crypto-assets, stablecoins, derivatives issued in the form of crypto, and certain non-fungible tokens ("NFTs").

D. A "Crypto-Asset" is defined as "a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions." A very narrow set of Crypto-Assets are then excluded from this definition to arrive at the definition of "Relevant Crypto-Assets," which excludes stablecoins that are redeemable at any time at par value for the same fiat currency on request of the holder (among other requirements), digital fiat currency issued by a central bank, and Crypto-Assets that cannot be used for payment or investment purposes.

E. “Reporting Crypto-Asset Service Providers,” (generally, brokers and trading platforms) are subject to CARF. “Reporting Crypto-Asset Service Providers” are defined as “any individual or Entity that, as a business, provides a service effectuating Exchange Transactions [i.e., exchanges between Relevant Crypto-Assets or between Relevant Crypto-Assets and Fiat Currencies] for or on behalf of customers, including by acting as a counterparty, or as an intermediary, to such Exchange Transactions, or by making available a trading platform.”

F. “Relevant Transactions,” are subject to reporting, and include crypto-to-crypto, crypto-to-fiat (or vice versa), and movement of Relevant Crypto-Assets between addresses or accounts (other than transfers between the same user’s accounts maintained at the same provider).

G. Notably, each calendar year (or other appropriate reporting period), Reporting Crypto-Asset Service Providers must report, for the individuals and entities participating in the transactions, a wide array of information including:

H. The name, address, jurisdiction(s) of residence, TIN(s) and date of birth of each entity or individual that is resident in a “Reportable Jurisdiction” which has an information exchange agreement with the relevant jurisdiction of the Reporting Crypto-Asset Service Provider. In the case of entities, the persons controlling such user must also be reported.

I. For each type of Relevant Crypto-Asset, with respect to which the provider has effectuated Relevant Transactions, the provider must, among other items, report: The aggregate fair market value, number of units, and number of Relevant Transactions in respect of acquisitions and dispositions against Fiat Currency and/or Relevant Crypto-Assets.

J. For reporting purposes, the rules require the aggregation (i.e. summing up) of all transactions attributable to each reporting category (crypto-for crypto, fiat-for-crypto, etc.) for each type of Relevant Crypto-Asset, reported in a single Fiat Currency (e.g., USD), valued at the time of each Relevant Transaction that is consistently applied. As a result, providers must track information on every crypto transaction, but only need report aggregate amounts (for each user) to government entities.

K. The aggregation rule does not apply to certain types of assets, such as NFTs. Reporting in respect of these assets presumably must be made on a transaction-by-transaction basis.

L. The aggregate fair market value, number of units, and number of “Reportable Retail Payment Transactions,” defined as a transfer of Relevant Crypto-Assets in consideration of goods or services for a value exceeding $50,000 USD.

M. CARF also expands on the due diligence requirements for Reporting Crypto-Asset Service Providers for both individual and entity users. The provider must obtain from a user a self-certification to determine the user’s residence for tax purposes and confirm the reasonableness of such based on AML/KYC procedures. The self-certification must contain: first and last name; residence address; jurisdiction of

residence for tax purposes; taxpayer identification number (TIN); date of birth. The provider must also obtain information regarding the person in control of an entity for entity users.