

SAN JOSE STATE UNIVERSITY/TAX EXECUTIVES INSTITUTE
U.S. INTERNATIONAL TAX ISSUES AND DEVELOPMENTS

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by

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I. TAX ACT.

- A. The corporate rate is now 21%.
- B. The § 163(j) interest-limitation rules limit deductions for business interest to the sum of (1) business interest income; (2) 30% of adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year.
- C. For taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed for § 163(j) purposes without regard to deductions allowable for depreciation, amortization and depletion.

D. Participation Exemption System.

1. The new rules allow an exemption for certain foreign income by means of a 100% deduction for the foreign-source portion of the dividends received from specified 10% owned foreign corporations by domestic corporations that are United States shareholders of those foreign corporations. See new § 245A.
2. The dividends received deduction (“DRD”) is not available for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend. Foreign tax credits are not permitted with respect to any portion of a distribution treated as a dividend if it qualifies for the DRD.
3. A domestic corporation is not permitted a DRD with respect to any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is treated as met only if the specified 10% owned foreign corporation is a specified 10% owned foreign at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10% owned foreign corporation at all times during the period.
4. To the extent dividends subject to the DRD are treated as “extraordinary dividends” under § 1059, they will reduce the domestic corporation’s basis in the foreign corporation’s stock.
5. The participation exemption will be of limited significance for many U.S.-based multinationals due to § 965’s mandatory repatriation and the inclusion of most CFCs’ earnings in the U.S. shareholder’s gross income under the global intangible low-taxed income (GILTI) rules discussed below. Distributions of the § 965 inclusion and GILTI amounts apparently will be treated in the same manner as distributions of previously taxed income (PTI) under § 959 and thus will not require – or qualify for – the participation exemption.
6. Unfortunately, these PTI distributions could also trigger very large amounts of currency gain or loss under § 986(c). Hopefully, this will be fixed in technical corrections. It was partially ameliorated in Notice 2018-07 regarding § 965 mandatory repatriation amounts. Until then, § 986(c) will be the 500-pound gorilla in the room.
7. Solely for the purposes of determining a loss, a domestic corporate shareholder’s adjusted basis in the stock of a specified 10% owned foreign corporation is reduced by an amount equal to the portion of any dividend received with respect to such stock from the foreign corporation that was not taxed by reason of a DRD allowable under § 245A.

8. In the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend for purposes of § 1248 is treated as a dividend for purposes of applying the participation exemption rules. Thus, a “§ 1248 deemed-paid foreign tax credit” will not be allowed.
9. If for any taxable year of a CFC, an amount is treated as a dividend under § 964(e)(1) because of a sale or exchange by the CFC of stock in another foreign corporation held for a year or more, then the foreign-source portion of the dividend is treated as Subpart F income of the selling CFC for purposes of § 951 and a deduction under § 245A is allowable to the U.S. shareholder with respect to the Subpart F income included in gross income as if the Subpart F dividend were received as a dividend by the shareholder from the selling CFC.
10. Under a branch-loss recapture rule, if a domestic corporation transfers substantially all of the assets of a foreign branch to a specified 10% foreign owned corporation with respect to which it is a U.S. shareholder, the domestic corporation must include in gross income an amount equal to the transferred loss amount.
11. The § 367 active trade or business exception from gain recognition was repealed.

E. Transition Deemed Mandatory Income Inclusions.

1. The treatment of deferred foreign income on transition to the participation exemption system is covered by a deemed mandatory repatriation subject to tax at a two-tier reduced tax rate under new § 965. In the case of the last tax year of a deferred foreign income corporation (DFIC) beginning before January 1, 2018 (that is, 2017 for a calendar-year taxpayer with calendar-year CFCs), the DFIC’s subpart F income is increased by the amount of accumulated post-1986 deferred foreign income.
2. DFICs include CFCs and all other foreign corporations (other than passive foreign investment companies) in which a U.S. person owns a 10 percent voting interest.
3. However, in the case of a foreign corporation that is not a CFC, there must be at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation.
4. These entities must determine their deferred foreign income based on the greater of the aggregate of post-1986 accumulated foreign earnings and profits as of November 2, 2017 or December 31, 2017, not reduced by any distributions during the taxable year ending with or including the

measurement date, unless those distributions were made to another specified foreign corporation.

5. Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation, including the pro rata share of deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S.-affiliated group. The Conference Report sets forth an example which we will not describe here.
6. The Conference Report states that the conferees are aware that certain taxpayers may have engaged in tax strategies designed to reduce the amount of post-1986 earnings and profits in order to decrease the amount of the inclusion required under this provision. Such tax strategies may include a change in entity classification, accounting method, and taxable year, or intragroup transactions such as distributions or liquidations. The conferees expect the IRS to prescribe rules to adjust the amount of post-1986 earnings and profits in such cases in order to prevent the avoidance of the purposes of this section.
7. The total deduction from the amount of the § 951 inclusion that results under § 965 is the amount necessary to result in a 15.5% rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and an 8% rate of tax on all other earnings. Individual U.S. shareholders and the investors in U.S. shareholders that are pass-through entities generally can elect the application of corporate rates for the year of inclusion.
8. Foreign tax credits that can be claimed are reduced commensurably with the reduced tax rate under § 965(g).

F. GILTI: The Income Inclusion.

1. Under new § 951A, GILTI must be included in income each year by CFCs' U.S. shareholders. For purposes of these rules, net deemed intangible income return is the excess (if any) of the net CFC tested income over each shareholder's net deemed tangible income return.
2. Net deemed tangible income return is the excess of 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC in which it is a U.S. shareholder over the amount of interest expense taken into account in determining its net CFC tested income for the tax year, to the extent that the interest income attributable to the interest expense is not taken into account in determining its net CFC tested income.

3. Under section 951A(f) the inclusion is treated “in the same manner” as Subpart F income for purposes of applying a number of Code provisions.
4. The Conference Report says the conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return and QBAI) to minimize tax under the new provision be disregarded. For example, the conferees expect the IRS to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under amended § 965 but before the final tax year for which new § 951A applies if these transactions are undertaken to increase a CFC’s QBAI.

G. GILTI and FDII: Deductions and Credits.

1. Special deductions relating to GILTI and foreign-derived intangible income (“FDII”) are set forth in IRC § 250.
2. Credits for foreign taxes “properly attributable to” GILTI are allowed under § 960 but subject to an 80% cap. Section 960 no longer is a multi-year pooling provision. The income and the taxes are included in a separate § 904(d) foreign tax credit basket. Excess credits cannot be carried back or forward.
3. Under a 21% corporate tax rate and as a result of the deduction for FDII and GILTI in § 250, the effective tax rate on FDII is 13.125% and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5% for taxable years beginning after December 31, 2017 and before January 1, 2026. Since only a portion (80%) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate with respect to GILTI at which no residual U.S. tax is owed by a foreign corporation is 13.125%.
4. If the foreign tax rate on GILTI is 0%, then the U.S. residual tax rate on GILTI is 10.5%. Therefore, as foreign tax rates on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5% and 13.125%. At foreign tax rates greater than or equal to 13.125%, there is no residual U.S. tax owed on GILTI, so the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.
5. The FDII rules provide that in the case of sales to a related party, the property sold must “ultimately” be sold, or “or used by a related party in connection with property which is sold or the provision of services,” to another person who is an unrelated foreign person for a foreign use. These rules could involve issues such as those litigated in *General Electric v. Commissioner*, 245 F.3d 149 (2d Cir. 2001) (DISC and the sale of aircraft

engines) and set forth in Treas. Reg. § 1.864-6(b)(3)(ii) (“Rules for Determining County of Use, Consumption or Disposition”).

6. Note that FDII is a destination rule, and does not turn on IP ownership.

H. Modifications Related to Foreign Tax Credit System.

1. Section 902 was repealed and § 960 foreign tax credits are determined on a current year basis
2. Conforming amendments were made to §§ 901(m), 904, 907, and 909 and to preserve the current applicability of §§ 901(m) and 909 to all taxpayers who claim foreign tax credits, including electing funds.
3. Significantly, § 863(b)’s 50-50 foreign-source export-sales rule was repealed.
4. Foreign branch income is allocated to a specific foreign tax credit basket.
5. There will be four primary foreign tax credit baskets under § 904(d): general, passive, GILTI and foreign branch income.
6. Foreign source income in the general basket apparently will be limited primarily to subpart F income (foreign base company sales income, etc.), foreign royalties (which presumably also are FDII) and foreign related-party look-through interest income. Since § 863(b) was repealed, there likely will be limited opportunities to generate additional general basket foreign-source income. Foreign branch income, of course, has its own basket.
7. The Treas. Reg. § 1.861-8 allocation and apportionment rules for allocating interest, expense, R&D, etc. to foreign-source income and baskets will need to be revised to account for these new rules. How the changes are made could be important.
8. There is an election to increase the percentage of domestic taxable income offset by overall domestic losses treated as foreign source. It provides an election to increase the percentage (but not greater than 100%) of domestic taxable income offset by any pre-2018 unused overall domestic loss and recharacterized as foreign source income. The term “pre-2018 unused overall domestic loss” means any overall domestic loss which:
(1) arises in a qualified taxable year beginning before January 1, 2018, and
(2) has not been used under the general rule set forth in § 904(g)(1). The provision applies to taxable years beginning after December 31, 2017.

I. Subpart F.

1. The inclusion based on the withdrawal of previously excluded Subpart F income from qualified investments under § 955 was repealed. The treatment of foreign-based company oil related income also was repealed.
2. Section 958(b) now provides for downward attribution in determining whether a foreign corporation is a CFC was adopted. This has resulted in many more CFCs, and lots of questions.
3. The definition of U.S. Shareholder in § 951(b) was expanded to include any U.S. person that owns 10% or more in the total value of shares of all classes of stock of the foreign corporation. The § 951 30-day requirement for an inclusion from a CFC was eliminated.
4. Subpart F, otherwise remains generally the same as it was: a CFC's foreign base company sales and service income and its foreign personal holding company as defined under § 954(c) are taxable to its U.S. shareholder. Section 956 was retained, but with a greatly reduced role. Section 960 foreign tax credits are available but based on current year taxes (no pooling).
5. Under new § 951A(f), GILTI included in the U.S. shareholder's income under § 951A is treated "in the same manner" as subpart F income included under § 951(a)(1)(A) in applying certain Code sections, including § 959. Thus, it has a priority over investments in U.S. property under § 956 if both provisions could apply in a given year. *See* § 959.
6. GILTI is includible in income even if foreign tax credits will shelter the GILTI amount from U.S. tax. A distribution of GILTI apparently is treated as a distribution of previously taxed income under § 959, subject to the foreign currency gain or loss rules of § 986(c).

J. Prevention of Base Erosion.

1. Under the base-erosion and anti-abuse minimum tax ("BEAT") provisions, an applicable taxpayer is required to pay a tax equal to the base-erosion minimum tax amount for the taxable year. The base-erosion minimum tax amount is the excess of 10% of the modified taxable income of the taxpayer for the taxable year over an amount equal to the regular tax liability of the taxpayer for the taxable year reduced by the excess (if any) of the credits allowed under Chapter 1 against the regular tax liability over the sum of certain § 38 credits.
2. A base-erosion payment means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer in respect to which a deduction is allowable. Base-erosion payments do not include any amount that constitutes reductions in gross receipts including

payments for cost of goods sold. However, base-erosion payment includes any amount that constitutes reductions in gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to a surrogate foreign corporation that is a related party of the taxpayer but only if that person first became a surrogate foreign corporation after November 9, 2017. Surrogate foreign corporation has the meaning given to it in § 7874(a)(2) but does not include a foreign corporation treated as a domestic corporation under § 7874(b).

3. A qualified derivative payment is not treated as a base-erosion payment. A qualified derivative payment means any payment made by a taxpayer pursuant to a derivative with respect to which the taxpayer: (1) recognizes gain or loss as if the derivative was sold for its fair market value on the last business day of the taxable year (and in such additional times as are required by the IRC or the taxpayer's method of accounting), (2) treats any gain or loss or recognizes ordinary, and (3) treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary. Derivative is defined in the Conference Report.

K. Other Changes.

1. Changes to § 367(d) and § 482 regarding aggregate basis valuation and application of the realistic alternative principle were adopted. Section 936(h)(3)(B) now defines intangible property to include goodwill, going concern value and workforce-in-place. The § 367(a)(3) "active trade or business" exception was repealed.
2. New § 267A denies a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. The IRS is to issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision for branches (domestic or foreign) and foreign entities, even if the branches or entities do not meet the statutory definition of hybrid entity.
3. Shareholders of inverted companies are denied the beneficial 20% "dividend" capital gains rate. However, the provision applies only to dividends received from foreign corporations that first became surrogate foreign corporations after the date of enactment.
4. Members of a U.S. affiliated group are prohibited from allocating interest expense on the basis of the fair market value of assets for purposes of § 864(e). Instead, the members must allocate interest expense based on the adjusted tax basis of assets.
5. *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017), was reversed. The calculation involves a deemed sale by the partnership of all

of its assets. The transferee now has a withholding tax obligation, which also can apply to the partnership itself if the transferee fails to withhold. Under the provision, a seller must provide a non-foreign affidavit to avoid having a portion of the sales proceeds withheld.

L. European Union.

1. There has been some discussion regarding the EU possibly challenging the FDII and BEAT provisions under World Trade Organization rules. This doesn't seem surprising given the EU's past aggressiveness towards DISC and FSC. Perhaps Congress should re-design the FDII to qualify as an EU patent-box provision.

II. SECTION 965 AND RELATED GUIDANCE.

A. Transition Deemed Mandatory Income Inclusions.

1. The treatment of deferred foreign income on transition to the participation exemption system is covered by a deemed mandatory repatriation subject to tax at a two-tier tax rate under new § 965. In the case of the last tax year of a deferred foreign income corporation (DFIC) beginning before January 1, 2018 (that is, 2017 for a calendar-year taxpayer with calendar-year CFCs), the DFIC's subpart F income is increased by the amount of accumulated post-1986 deferred foreign income.
2. DFICs include CFCs and all other foreign corporations (other than passive foreign investment companies) in which a U.S. person owns a 10 percent voting interest.
3. However, in the case of a foreign corporation that is not a CFC, there must be at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation.
4. These entities must determine their deferred foreign income based on the greater of the aggregate of post-1986 accumulated foreign earnings and profits as of November 2, 2017 or December 31, 2017, not reduced by any distributions during the taxable year ending with or including the measurement date, unless those distributions were made to another specified foreign corporation.
5. Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation, including the pro rata share of deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S.-affiliated group. § 965(b)(1); *see also* §§ 965(b)(4)(A) (reduced E&P amount treated as PTI) and 960(b) (distributions from PTI and foreign

taxes “properly attributable to such portion”). The Conference Report sets forth an example which we will not describe here.

6. The Conference Report states that the conferees are aware that certain taxpayers may have engaged in tax strategies designed to reduce the amount of post-1986 earnings and profits in order to decrease the amount of the inclusion required under this provision. Such tax strategies may include a change in entity classification, accounting method, and taxable year, or intragroup transactions such as distributions or liquidations. The conferees expect the IRS to prescribe rules to adjust the amount of post-1986 earnings and profits in such cases in order to prevent the avoidance of the purposes of this section.
7. The total deduction from the amount of the § 951 inclusion that results under § 965 is the amount necessary to result in a 15.5% rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and an 8% rate of tax on all other earnings. Individual U.S. shareholders and the investors in U.S. shareholders that are pass-through entities generally can elect the application of corporate rates for the year of inclusion.
8. Foreign tax credits that can be claimed are reduced commensurably with the reduced tax rate under § 965(g).

B. Proposed Regulations on § 965.¹

1. The transition tax implements proposed regulations (REG-104226-18) under § 965 have been released. They largely contain the rules set out in the three prior notices, with certain very important and significant modifications, as well as additional guidance. The regulations largely reject or reserve on most of the taxpayer comments and requests for clarifications. The regulations contain nine different sections.
2. Prop. Treas. Reg. § 1.965-1 provides general rules and definitions. Prop. Treas. Reg. § 1.965-2 provides E&P and basis to adjustment rules and a rule that limits the amount of gain recognized in connection with the application of § 961(b)(2). Prop. Treas. Reg. § 1.965-3 provides rules regarding the determination of § 965(c) deductions. Prop. Treas. Reg. § 1.965-4 sets forth rules that disregard certain transactions. Prop. Treas. Reg. §§ 1.965-5 and 1.965-6 provide rules with respect to foreign tax credits. Prop. Treas. Reg. § 1.965-7 provides rules regarding elections and payments. Prop. Treas. Reg. § 1.965-8 provides rules regarding affiliated groups. Prop. Treas. Reg. § 1.965-9 provides dates of applicability. The proposed regulation package also contains rules relating to § 962 elections

¹ The relevant § 965 Notices are discussed below, starting on p. 31, for ease in following and understanding the proposed regulations.

in Prop. Treas. Reg. §§ 1.962-1 and 1.962-2. Finally, Prop. Treas. Reg. § 1.986(c)-1 provides rules regarding the application of § 986(c) in connection with § 965.

3. Proposed Treas. Reg. § 1.965-1(b) provides the general rules on inclusion amounts. Prop. Treas. Reg. § 1.965-1(b)(1) provides that the Subpart F income of a deferred foreign income corporation (“DFIC”) is increased by the § 965(a) earnings amount.
4. Prop. Treas. Reg. § 1.965-1(b)(2) provides that the pro rata share of the DFIC’s § 965(a) earnings amount of a United States shareholder that owns section 958(a) stock, is reduced by the DFIC’s allocable share of the section 958(a) U.S. shareholder’s aggregate foreign E&P deficit. If a section 958(a) U.S. shareholder is a member of a consolidated group, all section 958(a) U.S. shareholders that are members of a consolidated group are treated as a single section 958(a) U.S. shareholder for this purpose.
5. The preamble states that the proposed regulations also clarify that because an increase in Subpart F income under § 965(a) is determined after the Subpart F income, neither the § 965(a) earnings amount nor the § 965(a) inclusion amount is subject to the rules or limitations in § 952 or otherwise limited by the accumulated E&P of the DFIC.
6. Prop. Treas. Reg. § 1.965-1(c) provides that a section 958(a) U.S. shareholder is generally allowed a deduction for a § 965(c) deduction amount. The preamble states that the proposed regulations clarify that a section 958(a) U.S. shareholder’s aggregate foreign cash position is applied against the aggregate § 965(a) inclusion amounts for a section 958(a) U.S. shareholder inclusion year. In the case of a section 958(a) U.S. shareholder with more than one section 958(a) U.S. shareholder inclusion year, the aggregate foreign cash position is allocated to each year and therefore the § 965(c) deduction amount is determined separately for each section 958(a) U.S. shareholder inclusion year.
7. A domestic partnership is treated as a foreign partnership if certain conditions are satisfied. *See* Prop. Treas. Reg. § 1.965-1(e)(1).
8. Prop. Treas. Reg. § 1.965-1(f) sets forth definitions for terms that apply for all of the proposed regulations under § 965, including the equivalent percentage, accounts payable and receivable, and aggregate foreign cash position definition. Consistent with Notice 2018-07, the definition of “post-1986 earnings and profits” clarifies, in Prop. Treas. Reg. § 1.965-1(f)(29)(i)(B), that the amount by which the post-1986 earnings and profits of a specified foreign corporation is reduced under § 965(d)(3)(B) as a result of a distribution made to a specified foreign corporation in the last taxable year of the foreign corporation that begins before January 1, 2018, may not exceed the amount by which the post-1986 earnings and

profits of the distribute corporation is increased as a result of the distribution.

9. Hovering deficits, are taken into account for purposes of determining the post-1986 earnings and profits (including a deficit) of a specified foreign corporation. *See* Notice 2018-13. The fact that hovering deficits are taken into account for purposes of determining post-1986 earnings and profits, and ultimately the § 965(a) inclusion amount of a section 958(a) U.S. shareholder, does not mean that hovering deficits are taken into account for any other purpose.
10. Comments noted that a specified foreign corporation that is not a CFC generally does not track E&P under U.S. tax principles and requested that taxpayers be allowed to use an alternative measurement method such as audited financial statements. This comment was not adopted.
11. The preamble states that there are numerous longstanding provisions in the Code where minority shareholders of foreign corporations must determine E&P consistent with § 312 and no alternative measurement method is provided.
12. Comments also requested that previously taxed E&P should be disregarded in determining a specified E&P deficit of an E&P deficit foreign corporation. The proposed regulations provide that previously taxed E&P is not excluded in determining the existence and amount of a specified E&P deficit, which is defined in reference to post-1986 earnings and profits and not in reference to accumulated post-1986 deferred foreign income. Treasury and the IRS are considering other rules with respect to the definitions of post-1986 earnings and profits, accumulated post-1986 deferred foreign income, and specified E&P deficit.
13. Prop. Treas. Reg. § 1.965-1(f)(7)(ii) clarifies that, for purposes of determining the accumulated post-1986 deferred foreign income of a specified foreign corporation as of an E&P measurement date, the E&P of the specified foreign corporation that are described in § 959(c)(2) (or that would be described in § 959(c)(2) applying the principles of Revenue Ruling 82-16, 1982-1 C.B. 106) by reason of Subpart F income are treated as described in § 965(d)(2)(B) and Prop. Treas. Reg. § 1.965-1(f)(7)(i)(B) or (f)(7)(i)(C) only to the extent that such income is accrued by the specified foreign corporation as of such E&P measurement date.
14. The definitions of the cash measurement dates, and of pro rata share are consistent with Notice 2018-26. *See* Prop. Treas. Reg. §§ 1.965-1(f)(24), (25), (30) and (31).
15. Treasury and the IRS have determined that the rules contained in § 1.441-2(c), which relate to the application of effective dates, are not relevant in

determining when a 52-53-week taxable year is considered to begin or end for purposes of the cash measurement dates; instead, the actual dates on which such a year begins and ends should be taken into account in determining cash measurement dates. Therefore, the proposed regulations do not contain the rule in Notice 2018-26 referring to § 1.441-2(c).

16. Consistent with Notice 2018-07, the proposed regulations address the treatment of derivative financial instruments for purposes of measuring the cash position of a specified foreign corporation.
17. Accounts receivable and payable are defined consistent with Notice 2018-13, including the clarification in Notice 2018-16. Comments requested modifications to the definition of accounts payable for purposes of determining a specified foreign corporation's cash position, including that accounts payable be defined to include payables related to the licensing of intellectual property, payables to employees in the ordinary course of business, and payables arising from property described in § 1221(a)(2). The term "accounts payable" is not defined in the statute, and Treasury and the IRS have determined that the definition in the proposed regulations is consistent with the ordinary meaning of accounts payable. Therefore no change is made in the proposed regulations to the definition of accounts payable.
18. Consistent with Notice 2018-13, Prop. Treas. Reg. § 1.965-1(f)(43) provides that a demand loan is a short-term obligation. In response to a comment, Prop. Treas. Reg. § 1.965-1(f)(43) clarifies that an instrument's term upon issuance is used for purposes of determining whether an obligation is a short-term obligation.
19. A comment requested that taxpayers be able to prove, based on facts and circumstances, that a demand loan should not be treated as a short-term obligation. Treasury and the IRS determined that any facts-and-circumstances test would not be administrable, particularly to the extent that the test required a determination of a taxpayer's subjective intent with respect to the payment of the loan. Accordingly, this comment was not adopted.
20. Consistent with Notice 2018-13, the proposed regulations provide that, for purposes of determining a United States shareholder's pro rata share of the specified E&P deficit of an E&P deficit foreign corporation that has multiple classes of stock outstanding, the specified E&P deficit is allocated among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders. *See* Prop. Treas. Reg. § 1.965-1(f)(30)(ii).
21. The preamble requested comments regarding whether there are circumstances in which a specified E&P deficit should be allocated to

shareholders of an E&P deficit foreign corporation's preferred stock and, if so, how to allocate as between shareholders of common stock and shareholders of preferred stock.

22. In the case of a domestic pass-through entity that is a section 958(a) U.S. shareholder with respect to one or more DFICs, each domestic pass-through owner takes into account its share of the aggregate § 965(a) inclusion amount with respect to § 958(a) stock of one or more DFICs of the domestic pass-through entity and its share of the § 965(c) deduction amount with respect to such amount (each, a “domestic pass-through owner share”), regardless of whether such domestic pass-through owner is also a United States shareholder with respect to such DFIC, giving rise to a “section 965(a) inclusion” and a “section 965(c) deduction” to the domestic pass-through owner. *See* Prop. Treas. Reg. § 1.965-1(f)(21), (37) and (41); *see also* Notice 2018-26.
23. The proposed regulations provide rules consistent with § 5 of Notice 2018-26 related to elections under § 962. Prop. Treas. Reg. § 1.962-2(a) clarifies that an individual domestic pass-through owner that is a United States shareholder with respect to a DFIC may make an election under § 962 with respect to the individual's share of the § 965(a) inclusion amount of a domestic pass-through entity with respect to the DFIC, and that an individual who is not a United States shareholder of a DFIC is not permitted to make an election under § 962 with respect to the individual share of a § 965(a) inclusion amount of a domestic pass-through entity with respect to the DFIC.
24. A helpful example appears in Prop. Treas. Reg. § 1.965-3(e)(2). The rule and the example might be helpful with respect to a private equity fund that invests in foreign corporations.

Example. (i) Facts. USI, United States citizen, owns 10% of the capital and profits of USPRS, a domestic partnership that has a calendar taxable year, the remainder of which is owned by foreign persons unrelated to USI or USPRS. USPRS owns all the stock of FS, a foreign corporation that is a controlled foreign corporation with a calendar taxable year. USPRS has a § 965(a) inclusion amount with respect to FS of \$1,000 and has a § 965 deduction amount of \$700. FS has no post-1986 foreign income taxes. USI makes a valid election under § 962 for 2017.

(i) Analysis. USI's “taxable income” described in Prop. Treas. Reg. § 1.962-1(b)(1)(i) = \$100 (USI's domestic pass-through owner share of USPRS's § 965(a) inclusion amount minus \$70 (USI's domestic pass-through owner's share of USPRS's § 965(c) deduction amount), with \$30. No other deductions are allowed in determining this amount. USI's tax on a \$30 § 965(a) inclusion will be equal to the tax that would be imposed on that amount under § 11 if USI were a domestic corporation. Under Prop. Treas. Reg. § 1.965-3(e)(1), USI cannot deduct \$70 for

purposes of determining USI's taxable income that is subject to tax under § 1.

25. Thus, under Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B), "taxable income" as used in § 11 is reduced by a taxpayer's § 965(c) deduction with respect to a § 965(a) inclusion to which the § 962 election applies.
26. The preamble further states that "however, the proposed regulations clarify that, subject to future guidance 'taxable income' as used in § 11, is not reduced by other amounts including any other deductions." Thus, similar treatment would seem not be available for other deductions absent further guidance explicitly providing to that effect. This obviously leaves open questions regarding GILTI and § 250.
27. Eight examples in the proposed regulations illustrate the definitions and general rules.
28. Prop. Treas. Reg. § 1.965-2 contains rules related to adjustments to E&P and basis to determine and account for the application of §§ 965(a) and (b) and add a rule that limits the amount of gain recognized under § 961(b)(2).
29. Prop. Treas. Reg. § 1.965-2(e) provides that, under § 961(a), a § 958(a) U.S. shareholder's basis in § 958(a) stock of a DFIC, or property by reason of which the § 958(a) U.S. shareholder is considered under § 958(a)(2) as owning § 958(a) stock of a DFIC ("applicable property"), is increased by the § 958(a) US Shareholder's § 965(a) inclusion amount with respect to the DFIC. Rules relating to basis adjustments in the case of § 962 elections are reserved. Comments are requested as to the appropriate amount of a basis adjustment with respect to a DFIC with respect to which a § 962 election is effective.
30. Prop. Treas. Reg. § 1.965-2(f)(1) clarifies that, in general, no adjustments to basis of stock or property are made under § 961 (or any other provision of the Code) to take into account the reduction to a § 958(a)'s US shareholder's pro rata share of the § 965(a) earnings amount of a DFIC under the reduction rules. However, § 965(o) provides authority for Treasury and the IRS to write regulations concerning basis adjustments in contemplation of the fact that basis adjustments (increases or decreases) may be necessary with respect to both the stock of the DFIC and the E&P deficit foreign corporation.
31. Treasury and the IRS have determined that an increase to the basis of stock of DFICs is appropriate only if there is a corollary reduction to the basis of the stock of E&P deficit foreign corporations. Treasury and the IRS recognize that such reduction, which could in certain cases give rise to gain, could be overly burdensome for taxpayers.

32. Accordingly, Prop. Treas. Reg. § 1.965-2(f)(2) allows taxpayers to elect to make the relevant basis adjustments, in which case the adjustments must be consistently made with respect to all § 958(a) stock of specified foreign corporations owned by a § 958(a) U.S. shareholder and related persons. The relevant basis adjustments are:
- (a) An increase in the § 958(a) U.S. shareholder's basis in the § 958(a) stock of a DFIC or applicable party with respect to a DFIC by an amount equal to the § 965(b) previously taxes earnings and profits of the DFIC with respect to the § 958(a) U.S. shareholder; and
 - (b) A reduction in the § 958(a) U.S. shareholder's basis in the § 958(a) stock of an E&P deficit foreign corporation or applicable property with respect to an E&P deficit foreign corporation by an amount equal to the portion of the § 958(a) U.S. shareholder's pro rata share of the specified E&P deficit of the E&P deficit foreign corporation taken into account under the reduction rules.
33. An election under the Prop. Treas. Reg. § 1.965-2(f)(2) is generally made by attaching a statement, signed under penalties of perjury, to the § 958(a) U.S. shareholder's return for the first taxable year the includes the last day of the last taxable year of a DFIC or E&P deficit foreign corporation of the shareholder that begins before January 1, 2018, including the shareholder's name and taxpayer identification number and a statement that the shareholder and all related persons make the election.
34. Six examples illustrate the E&P and basis adjustments rules.
35. Prop. Treas. Reg. § 1.965-3 provides rules regarding section 965(c) deductions and deduction amounts. The rules disregard certain asset transfers and other assets upon demonstration of double counting for purposes of determining the aggregate foreign cash position.
36. Consistent with Notice 2018-07, the proposed regulations provide that, for purposes of determining the aggregate foreign cash position, accounts receivable, accounts payable, short-term obligations, and derivative financial instruments between related specified foreign corporations are disregarded, if applicable, on the corresponding cash measurement dates of the specified foreign corporations to the extent of the smallest of the section 958(a) U.S. shareholder's ownership percentages of § 958(a) stock of the specified foreign corporations owned by the section 958(a) U.S. shareholder on the corresponding cash measurement dates. *See* Prop. Treas. Reg. § 1.965-3(b)(1).
37. Consistent with Notice 2018-26, documentation necessary to exclude certain assets is discussed in Prop. Treas. Reg. § 1.965-3(b)(2). An important tax–return statement is necessary.

38. Four examples illustrate the rules for disregarding certain assets for purpose of determining the aggregate foreign cash position.
39. Prop. Treas. Reg. § 1.965-4 (anti-avoidance rules) provides rules that disregard certain transactions for purposes of applying § 965. In particular, Prop. Treas. Reg. § 1.965-4 provides rules that disregard (i) transactions undertaken with a principal purpose of reducing the § 965 tax liability, (ii) certain changes in method of accounting and entity classification elections, and (iii) certain transactions occurring between E&P measurement dates. *See* Notice 2018-26
40. Comments requested that the anti-avoidance rule not apply to the extent a reduction in tax liability by reason of § 965 is offset by an equal amount of tax increase pursuant to a different Code provision. This comment was not adopted.
41. Comments also requested a de minimis exception for the anti-avoidance rule. This comment was not adopted.
42. Comments requested that the rule disregarding changes to methods of account not apply when the change is from an impermissible to a permissible method, and that a principal purpose test should apply. These comments were not adopted.
43. A number of comments requested that the rules of Notice 2018-07 be expanded to cover other transactions that could lead to double counting and double non-counting in the computation of post-1986 earnings and profits, including: (i) deductible payments by a specified foreign corporation to a United States shareholder or to a partnership owned by the United States shareholder; and (ii) distributions by specified foreign corporations to a United States shareholder. The recommendations in these comments were not adopted.
44. Prop. Treas. Reg. § 1.965-5 contains the rules for the allowance of a credit or deduction for foreign income taxes. The proposed regulations provide that neither a deduction nor a credit under § 901 is allowed for the applicable percentage of any foreign income taxes paid or accrued with respect to any amount for which a section 965(c) deduction is allowed for a § 958(a) U.S. shareholder inclusion year.
45. Prop. Treas. Reg. § 1.965-5(c)(1)(ii) addresses foreign tax credits for 2017 regarding distributions of PTI under § 960(a)(3). It states that no credit is allowed under § 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under § 960(a)(1) with respect to a portion of the § 965(a) earnings amount that is reduced under Prop. Treas. Reg. § 1.965-1(b)(2) or § 1.965-8(b). The first section deals with § 965(b); the second with “Reduction of E&P net surplus shareholder’s

pro rata share of § 965(a) earnings amount of DFIC by allocable share of the applicable share of aggregate unused E&P deficit.”

46. This does not seem right or supportable under the statute. The preamble states that, under the proposed regulations, the credit allowed under § 960(a)(3) is only regarding foreign income taxes imposed on an upper-tier foreign corporation on distributions of § 965(a) previously taxed earnings and profits or § 965(b) previously taxed earnings and profits from a lower-tier foreign corporation.
47. Furthermore, and more importantly, it states that § 960(a)(3) does not allow a credit for foreign income taxes attributable to the portion of a § 965(a) earnings amount that was reduced pursuant to § 960(b) (dealing with deficits) since these taxes were not imposed on a distribution of previously taxed E&P. Instead, because § 965(b) previously taxed earnings and profits are treated as having been included in the United States shareholder’s income under § 951(a), foreign income taxes that would have been paid with respect to § 965(b) previously taxed earnings and profits under § 960(a)(1) had such amounts actually been included in income are treated as having been deemed paid, with the result that no credit is allowed under § 960(a)(3) or any other section of the Code for these taxes.
48. Treasury and the IRS would seem to have taken the position that, because § 965(b)(4)(A) states that an amount equal to the shareholder’s reduction under § 964(b)(4) that is allocated to a DFIC is treated as an amount that was included in the gross income of such United States shareholder under § 951(a), that amount is deemed distributed. Thus, Treasury and the IRS seem to have invented a new term: “deemed deemed-paid foreign tax credit.” However, § 965(b)(4) says that it applies only “for purposes of applying § 959.”
49. Thus it seems erroneous for Treasury and the IRS to say that the amounts were included in income and that the deemed-paid credits were deemed claimed. Outside of that section (which as noted applies “for purposes of § 959”) there would seem to be no way in which that amount and that credit could be treated as having been deemed paid so as to deprive the U.S. parent company of a credit for those taxes.
50. The Tax Act replaced § 960(a)(3) with § 960(b) for years beginning in 2018 and going forward. The proposed regulations only address distributions out of § 965(a) previously taxed earnings and profits and § 965(b) previously taxed earnings and profits for years before the effective date of § 960(b), i.e., for 2017 only. Treasury and the IRS state that they anticipate that future regulations will provide similar rules in connection with new § 960(b). Accordingly, Prop. Treas. Reg. § 1.965-

5(c)(1)(iii) is “reserved” with respect to “foreign income taxes deemed paid under § 960(b).”

51. This also seems wrong. Section 960(b) provides that if any portion of a distribution from a CFC to a domestic corporation which is a United States shareholder with respect to the CFC is excluded from gross income under § 959(a), the domestic corporation will be deemed to have paid so much of the foreign corporation’s foreign income taxes as are properly attributable to that portion and that have not been deemed to have been paid by the domestic corporation under § 960 for the taxable year or any prior taxable year.
52. The taxes in question are properly attributable to the distributed portion of the previously taxed earnings and indeed will not have been deemed paid by the domestic corporation for the taxable year or any prior taxable year (or apparently, under the proposed regulation, ever).
53. Compare the seemingly inconsistent treatment, and inconsistent conceptual analysis, here with that under Prop. Treas. Reg. § 1.986(c), discussed below.
54. Prop. Treas. Reg. § 1.965-6 provides the rules for the computation of foreign income taxes deemed paid and for the allocation and apportionment of deductions. Comments requested clarification regarding the determination of deemed paid taxes under § 960 in connection with § 965. The proposed regulations confirm that for years prior to the repeal of § 902, §§ 902 and 960 apply in the same manner for section 965(a) inclusions as for other inclusions under § 951(a)(1)(A), and therefore a DFIC’s post-1986 undistributed earnings are not reduced by specified E&P deficits from an E&P deficit foreign corporation.
55. For the avoidance of doubt, the proposed regulations clarify that when the denominator of the § 902 fraction is positive but less than the numerator of such fraction, the § 902 fraction is one. *See* Prop. Treas. Reg. § 1.965-6(c)(2).
56. Comments also requested that taxpayers be deemed to pay taxes when the denominator of the § 902 fractions is zero or less than zero, either by treating the DFIC as having post-1986 undistributed earnings equal to the DFIC’s post-1986 foreign income taxes, or by determining the DFIC’s post-1986 undistributed earnings as of the measurement date used to determine its § 965(a) earnings amount. This comment was not adopted. The proposed regulations confirm that when the denominator of the § 902 fraction is zero or less than zero, no taxes are deemed paid with respect to the section 965(a) inclusion. *See* Prop. Treas. Reg. § 1.965-6(c)(2).

57. Comments also recommended that, to the extent that a hovering deficit is treated as reducing the post-1986 earnings and profits of a DFIC, those taxes should be added to the DFIC's post-1986 foreign income taxes in the inclusion year with respect to the DFIC. Treasury and the IRS have determined that the existing rules adequately address this issue and declined to adopt this comment.
58. The proposed regulations do not address the assignment of a section 965(a) inclusion and the related taxes to a separate category of income. Treasury and the IRS have determined that the application of § 904 is clear and that no clarification is necessary with respect to § 1.904-6 for purposes of relating the creditable portion of the foreign income taxes with respect to a section 965(a) inclusion to a separate category of income.
59. Treasury and the IRS request comments on whether more guidance is necessary with respect to the assignment of the section 965(a) inclusion and the related taxes to a separate category or categories of income.
60. In addition, comments are requested on whether additional rules are needed for determining the amount of the increase in the § 904 limitation with respect to distributions of § 965(a) previously taxed earnings and profits and § 965(b) previously taxed earnings and profits, taking into account the section 965(c) deduction and the disallowed foreign taxes under § 965(g).
61. Elections, payment and other special rules are in Prop. Treas. Reg. § 1.965-7. Comments requested clarification regarding whether the underpayment of an installment would constitute an acceleration event under § 965(h)(3) or would result in the proration under § 965(h)(4). The proposed regulations provide that if a person is assessed a deficiency, the person timely files a return increasing the amount of its § 965(h) net tax liability above the amount taken into account in the payment of the first installment, or the person files an amended return increasing the amount of its § 965(h) net tax liability, the deficiency or additional amount will be prorated among the installments under § 965(h)(4). This proration rule does not apply if the deficiency or additional liability is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax, in which case, the proposed regulations clarify that the deficiency is payable on notice and demand. *See* Prop. Treas. Reg. § 1.965-7(b)(1)(ii)(C).
62. Prop. Treas. Reg. § 1.965-7(b)(3)(ii) lists the events treated as acceleration events. Prop. Treas. Reg. § 1.965-7(b)(3)(ii)(B) provides that, in addition to a liquidation or sale of substantially all of the assets of a taxpayer, any exchange or other disposition of substantially all of the assets of a taxpayer constitutes an acceleration event. In addition, Prop. Treas. Reg.

§ 1.965-7(b)(3)(ii)(D) provides that any event that results in a person no longer being a United States person is an acceleration event.

63. The proposed regulations provide an exception to the acceleration provisions. Generally, acceleration events eligible for this exception include (i) liquidations, sales, exchanges, or other dispositions of substantially all of the assets of a person (with the exception of, in the case of an individual, by reason of death, and with special rules applying in the case of a consolidated group), (ii) a corporation that was not a member of any consolidated group becoming a member of a consolidated group, and (iii) a consolidated group ceasing to exist by reason of acquisition and immediately joining another consolidated group. In each case, the exception applies only to the extent that the person with respect to which an acceleration event occurs and an eligible § 965(h) transferee enter into a transfer agreement described in Prop. Treas. Reg. § 1.965-7(b)(3)(iii)(B).
64. Prop. Treas. Reg. § 1.965-8 provides rules regarding affiliated groups. The proposed regulations clarify that for purposes of computing the foreign income taxes deemed paid with respect to a section 965(a) inclusion, the foreign income taxes deemed paid must be computed on a separate member basis.
65. For purposes of computing a member's § 965(c) deduction, the member's aggregate foreign cash position generally is determined by reference to its pro rata share of the consolidated group's aggregate foreign cash position as a whole.
66. Prop. Treas. Reg. § 1.965-9 contains the applicability dates. Sections 1.965-1 through 1.965-8 apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends. The proposed regulations provide that Prop. Treas. Reg. § 1.965-4 applies regardless of whether the transaction, effective date of a change in method of accounting, effective date of any entity classification election, or specified payment occurred in a prior taxable year.
67. Application of § 986(c).
 - (a) The proposed regulations provide that, for purposes of § 986(c), foreign currency gain or loss with respect to distributions of § 965(a) previously taxed earnings and profits is determined based on movements in the exchange rate between December 31, 2017, and the date on which the E&P is actually distributed. Prop. Treas. Reg. § 1.986(c)-1(a), *see also* Notice 2018-13.

- (b) Consistent with § 3.05 of Notice 2018-07, the proposed regulations also provide that any gain or loss recognized under § 986(c) with respect to distributions of § 965(a) previously taxed earnings and profits is reduced in the same proportion as the reduction by a § 965(c) deduction amount of the § 965(a) inclusion amount that gave rise to such § 965(a) previously taxed earnings and profits, consistent with the statute and other indicia of Congressional intent. Prop. Treas. Reg. § 1.986(c)-1(b).
- (c) Because § 965(b) previously taxed earnings and profits are not included in gross income under § 951(a)(1), Treasury and the IRS determined it would not be appropriate to apply § 986(c) with respect to distributions of that E&P. Therefore, Prop. Treas. Reg. § 1.986(c)-1(c) provides that § 986(c) does not apply with respect to distributions of § 965(b) previously taxed earnings and profits.
- (d) Note the inconsistency here with the rationale under Prop. Treas. Reg. § 1.965-4, which denies the related foreign tax credits on the grounds that, at least theoretically, these amounts were deemed distributed.

68. Repeal of § 958(b)(4).

- (a) Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year, and for the taxable years of United States shareholders in which or with which such taxable years of the foreign corporations and the Tax Act repealed § 958(b)(4). Before repeal, § 958(b)(4) provided that subparagraphs (A), (B), and (C) of § 318(a)(3) were not to be applied to consider a United States person to own stock which is owned by a person who is not a United States person. The subparagraphs of § 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called “downward” attribution).
- (b) Multiple comments requested guidance be issued addressing the repeal of § 958(b)(4). Treasury and the IRS said that this issue is beyond the scope of the § 965 proposed regulations.
- (c) However, consistent with § 5.02 of Notice 2018-13, the instructions to Form 5471 will be amended to provide an exception from certain filing requirements for a United States person that is a United States shareholder with respect to a CFC or other specified foreign corporation if no United States shareholder (including the United States person) owns, within the meaning of § 958(a), stock of the CFC or other specified foreign corporation, and the foreign corporation is a CFC or specified foreign corporation solely

because a United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under § 318(a)(3). Consistent with § 6 of Notice 2018-13 and § 7 of Notice 2018-26, taxpayers may rely on this exception with respect to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent year of the foreign corporation, and for the taxable years of a United States shareholder in which or with which these taxable years of the foreign corporation end.

C. Comments On Proposed 965 Regulations

1. The public hearing for § 965 was held on October 22, 2018. A large number of helpful comments have already been submitted including comments by the New York State Bar Association Tax Section (“NYSBA”), The Chamber of Commerce (“The Chamber”), The National Foreign Trade Council (“NFTC”), The National Association of Manufacturers (“NAM”), Tax Executives Institute (“TEI”) and The Silicon Valley Tax Directors Group (“SVTDG”),
2. NYSBA Comments. The NYSBA comments on the proposed transition tax regulations under § 965, address a number of issues including the double counting rule, refunds for taxpayers making the installment election and the previously tax income (PTI) cliff effect. The report also responds to previous recommendations that Treasury and the IRS rejected in the preamble to the proposed regulations.
3. Under the double counting rule in Prop. Treas. Reg. § 1.965-4(f)(1) certain specified payments are disregarded to prevent double counting. A payment will not be a specified payment unless the payor and the payee have different tentative E&P measurement dates. The proposed regulations do not specify how the tentative E&P measurement date is to be determined. The NYSBA recommends that Treasury and the Service clarify this issue.
4. The application of the double counting rule can also result in an artificial reduction in the creditable foreign taxes. The NYSBA recommends that the final regulations provide that a payment that is disregarded under the double counting rule for E&P purposes is also disregarded for purposes of determining the foreign taxes deemed paid.
5. Certain transactions are disregarded for purposes of determining the 965 elements. Prop. Treas. Reg. § 1.965-4(c)(2) provides that a check-the-box election that is filed after November 2, 2017 is disregarded for purposes of determining the 965 elements if giving it effect would in fact change any 965 element. The report recommends that guidance is needed on transactions that follow a check-the-box election. For example, the final

regulations could provide that if a transaction is disregarded for purposes of determining the 965 elements, but subsequent related transactions are not, that the effect of the subsequent transactions on a U.S. shareholder's 965 elements is determined as if Prop. Treas. Reg. § 1.965-4(b) or (f) did not apply to the earlier step.

6. The NYSBA recommends excluding § 965(h) installment payments from the application of § 6403. If Treasury and the Service decline to adopt this approach, the NYSBA recommends guidance that distinguishes between § 965(h) installment overpayments and overpayments of estimated taxes or regular income taxes.
7. They also recommend that Treasury and the Service allow for relief for over-payments made in respect of § 965(h) installment that are attributable to systemic uncertainty, such as payments made before guidance was released. To the extent this is not resolved, the NYSBA encourages Congress to consider a statutory amendment.
8. If Treasury and the Service believe they lack the authority to adopt a rule that adjusts cash positions to account for PTI, the NYSBA recommends that Congress consider a statutory amendment.
9. Prop. Treas. Reg. § 1.965-2(d)(1) read literally, states that if the U.S. shareholder has no § 965(a) then none of the E&P becomes § 965(b) PTI. However, if the U.S. shareholder has at least one cent of § 965(a) inclusion, then the E&P offset by the allocated deficit does become § 965(b) PTI. This rule creates a cliff effect that can lead to dramatically different consequences. The NYSBA recommends that the final regulations conform to the statute and eliminate the requirement for the U.S. shareholder to have a § 965(a) inclusion in order for the E&P offset by an allocated deficit to become § 965(b) PTI.
10. The NYSBA states at p. 9 of its report that disallowing credits on foreign income taxes on distributions of § 965(b) PTI may be inconsistent with the plain language of the statute. The proposed regulations would not allow any portion of the foreign taxes for distributions of § 965(b) PTI if the allocable share of deficits equals or exceeds the allocable share of deferred E&P. This result is inconsistent with § 965(g), which ties the foreign tax credit haircut to the amounts for which a deduction is allowed under § 965(c). The NYSBA recommends the final regulations confirm this result.
11. The recent NYSBA report has a section discussing and commenting on previous NYSBA recommendations were not implemented in the proposed regulations.

12. The NYSBA previously requested simplifying conventions for determining deferred E&P and cash positions as of the various measurement dates. Treasury and the Service considered this recommendation but declined to adopt regulations addressing the issue, stating that the administrative burdens imposed under § 965 are not unique or novel. The preamble asserts minority shareholders of foreign corporations must determine E&P consistent with § 312 if they own stock in a passive foreign investment company and elect to treat the PFIC as a qualifying electing fund. NYSBA views these comparisons inapposite and strongly advocates the need for additional guidance on simplifying conventions. The report states since § 965 imposes new and in many cases unanticipated administrative burdens on minority U.S. shareholders, Treasury and the Service should reconsider their position and issue further guidance permitting shareholders to apply simplifying conventions in determining E&P and cash positions.
13. The NYSBA reiterated the recommendation to amend the § 961 regulations to clarify that basis decreases under § 961(b) and gain recognition under § 961(b)(2) do not occur prior to giving effect to basis increases under § 961(a). This issue is not unique to § 965, but has received increased attention due to the significant amount of PTI created by § 965. Amending the § 961 regulations would solve the issue at a systemic level for all types of previously taxed earnings, whether created by §§ 965, 951A, or 951(a). Alternatively, they suggest that the final § 965 regulations provide an ordering rule that specifies that distributions are sourced first from § 965 PTI before other types of PTI and amend Examples 1 and 2.
14. The proposed regulations do not include the CFC to CFC gain-reduction rule announced in Notice 2018-13, and the preamble to the proposed regulations does not explain its absence. It is unclear if Treasury determined that a CFC to CFC gain-reduction rule is unnecessary. The NYSBA states that if Treasury and the Service believe that § 961(c) does require gain recognition, they recommend including the CFC to CFC gain-reduction rule in the final § 965 regulations.
15. The NYSBA recommends that Treasury revise the basis reallocation election to limit the amount of the basis reallocation to the lesser of the existing basis in the stock of the deficit CFC (or applicable § 961 property) or the amount of the E&P deficit so as to not result in immediate gain recognition with respect to the deficit CFC stock (or applicable § 961 property).
16. The prior NYSBA report identified that distributions occurring between November 2 and December 1, 2017 could result in double counting of E&P. In the preamble to the proposed regulations, Treasury and the Service stated that they had determined not to adopt any recommendations

in this regard, because such payments only affect the E&P of a single specified foreign corporation (“SFC”), and thus do not result in double counting in determining a U.S. shareholder’s § 965(a) inclusion amount. The preamble notes, the attendant U.S. tax effects, including the indirect foreign tax credits that a U.S. shareholder might have been eligible to claim. The NYSBA does not think that rationale is convincing, because there clearly is a potential for taxpayers to be subject to taxation on the same earnings twice, and the double taxation results from the application of § 965.

17. The prior NYSBA report recommends that Treasury and the Service consider expanding the definition of “accounts payable” for purposes of determining the cash position beyond the narrow definition set forth in Notice 2018-3. The preamble to the proposed regulations states that this definition is consistent with the “ordinary meaning” of accounts payable. The NYSBA report notes that Rev. Proc. 99-32 permits a U.S. taxpayer to establish an account payable and is an example of the Service itself treating accrued but unpaid royalties as creating an account payable.
18. **The Chamber Comments.** The Chamber comments on the proposed transition tax regulations address a number of the same issues and some different issues.
19. Like TEI, the Chamber recommends fixing the double counting issues. The Chamber states that it does not follow the policy of § 965 to include in the § 965 inclusion amount earnings which have been fully taxed in the United States. Income which has been fully taxed in the United States is not deferred. The fact that a U.S. company may have received foreign tax credits on the distribution does not support double taxing these amounts. The applicability of tax credits does not change the fact that these earnings are no longer deferred but fully subject to U.S. taxation. It goes against the policy of the U.S. tax credit regime to make taxable distributions subject to additional U.S. taxation.
20. The Chamber comments that the definition of “personal property which is of a type that is actively traded and for which there is an established financial market” in Treas. Reg. § 1.965-1(f)(13)(i) should exclude publicly traded stock held in the ordinary course of the taxpayer’s trade or business. The preamble states that liquidity-based exceptions are not administrable and contrary to Congressional intent in determining the value of actively traded property. However, Chambers recommends reconsidering this issue since it was Congressional intent to impose a higher tax on a taxpayer’s liquid assets. Publicly traded shares held in the ordinary course of trade or business are often held as a key component of the international operations and form a critical part of the supply chain. The fact that a portion of the subsidiary’s stock is floated publicly does not detract from the role in the day-to-day business operations. Moreover,

these shares are not sufficiently liquid to be treated as a cash equivalent when they represent a significant shareholding.

21. The Chamber recommends excluding from a U.S. shareholder's aggregate foreign cash position any obligation with an amount determined under § 956, to the extent of (i) the amount included in gross income under § 951(a)(1)(B) plus (ii) the amount excluded from gross income under § 959(a)(2). Excluding obligations that constitute U.S. property under § 959(c) would not create an administrative burden as claimed in the Preamble. Determining the existence and amounts of U.S. loans can be shown through routine tax filings and do not require a "facts-and-circumstances test." U.S. loans that are funded with earnings that have already been subject to U.S. tax are not a reinvestment of deferred foreign income in cash equivalents.
22. The Chamber recommends excluding PTI from determining the existence and amount of a specified E&P deficit. The statute is silent with respect to PTI in the case of deficit company. Given that the statute is silent, the Chamber disagrees that Treasury's interpretation of the statute is the only possible interpretation. Consistent with the rules for calculating deferred foreign income, the rules for calculating earnings deficits should exclude the amount of undistributed foreign earnings that have already been subject to U.S. tax. The Chamber believes adopting this position would align the regulation with the intent of Congress that the transition tax should apply to a taxpayer's net, historic foreign earnings which had not been previously taxed. Further, the Chamber believes that this calculation achieves the most accurate measure of a taxpayer's E&P that should be subject to the transition tax.
23. The Chamber recommends increasing the partnership applicable attribution threshold to a more meaningful percentage, such as 10%. Prop. Treas. Reg. § 1.965-1(f)(45)(ii) limits partnership attribution buy only if the tested partner owns less than 5%. Limiting the de minimis amount to less than 5% still presents significant compliance difficulty. Other partners of a partnership are not generally willing to share detailed information about their holdings.
24. Prop. Treas. Reg. § 1.965-1(g), *Ex. 1* and 2, should be modified so that downward attribution of stock from a partner to a partnership is turned off when the partner owns less than a five percent interest in the partnership, but in a manner that is not contrary to the statutory prohibition on sideways attribution set forth in § 318(a)(5)(C).
25. The Chamber recommended clarification that the foreign tax credit ordering rules follow the Prop. Treas. Reg. § 1.965-2(b) ordering rules.

26. The Chamber also recommends rules providing that § 959(c)(3) earnings cannot be reduced below zero as a result of the § 965 inclusion. At a minimum, they recommend clarification under § 960(a) that the existence of a prior deficit in § 959(c)(3) earnings does not preclude the recognition of current year foreign tax credits attributable to current year Subpart F income. The reduction of § 959(c)(3) pools below zero from the § 965 inclusion presents potential pitfalls. The § 965 PTI is trapped because a CFC can only distribute PTI to the extent of its aggregate positive E&P. Also there is a risk if the CFC has Subpart F income going forward, the current tax credits will not be available because of the net negative accumulated § 959(c)(3) earnings.
27. Clarification is requested that the basis adjustments flow down through the CFC tiers under § 961(c) in proportion to the E&P deficit.
28. Treasury should provide basis for § 965(b) PTI such that any distribution of such PTI would not be subject to future tax at the full tax rate or, alternatively, provide that § 961(b) basis reductions are not required in respect of distributions of § 965(b) PTI. Treasury has the authority in § 965(o) to make this modification to the proposed regulations. The Conference report also authorizes Treasury to make the suggested modifications.
29. The Chamber recommends that the gain reduction rule applies first to available § 965(a) PTI and that only after available § 965(a) PTI has been fully distributed, should the gain reduction rule be applicable to § 965(b) PTI. In the absence of an ordering rule governing PTI, taxpayers will be uncertain as to the tax consequences of a distribution of § 965 PTI.
30. The Chamber recommends restoring the rules for disregarding obligations between related SFCs. Prop. Treas. Reg. § 1.965-3(b)(1) disregards obligations between related SFCs for purposes of measuring the U.S. shareholder's aggregate cash position only to the extent that the obligation exists on the same cash measurement date for both the counterparty SFCs. This is a significant change from the prior notice (Notice 2018-7). Notice 2018-7, § 3.01(b) that provides that obligations between related SFCs are disregarded to the extent of common ownership without regard to whether the obligation exists in respect of both counterparty SFCs on the same cash measurement date.
31. The Chamber recommends that cash be considered as an asset eligible for the exclusion under Prop. Treas. Reg. § 1.965-3(b)(2) otherwise there could be double counting of cash.

The Chamber recommends that an increase in § 960 deemed paid credit should not count as a change in a § 965 element for purpose of the

accounting method change if it is as a result of an increase in the § 965 inclusion.

32. They recommend amending the automatic method change procedures to disregard deemed paid foreign tax credits resulting from the application of § 965.
33. The Chamber states that the entity classification rule should not apply to a check-the-box election that changes the U.S. shareholder from a domestic pass-through entity to a C corporation (or vice versa).
34. In terms of double counting issues, the Chamber recommends modifying the Prop. Treas. Reg. § 1.965-4(f) rule to provide that in the case of specified payments occurring in the ordinary course of business, Prop. Treas. Reg. § 1.965-4(f) should not apply if it results in the double counting of E&P. The Chamber recommends revising the rule so that a payment which results in double counting reduces the payor's § 965 inclusion amount without any adjustment to the payee's § 965 amount to solve the mismatch of § 959(c)(2) and (c)(3) earnings and avoid the trapped PTI/nimble dividend issues moving forward. Treasury should clarify that the Prop. Treas. Reg. § 1.965-4(f) double counting rules apply in cases where disregarding a specified payment results in the payee switching its measurement date, which then creates new specified payments which should also be disregarded or else they will be double counted in the U.S. shareholder's § 965 inclusion.
35. Prop. Treas. Reg. § 1.965-5(c)(1)(ii) limits § 960(a)(3) PTI taxes to foreign income taxes paid or accrued by an "upper-tier foreign corporation" with respect to a "distribution" of PTI from a "lower-tier foreign corporation." The Chamber recommends clarification that references to "upper-tier foreign corporation" includes a disregarded entity or partnership.
36. The Preamble states at p. 3, number 9 that foreign taxes which are not included by a U.S. shareholder under § 965 as a result of the § 965(b) loss allocation cannot be credited under § 960(a)(3) since these taxes were not imposed on a distribution of PTI and § 965(b) earnings are "treated as having been included in a U.S. shareholder's income under § 951(a)" and, therefore, the related taxes are treated as having been deemed paid. These taxes should meet the requirements of § 960(a)(3) as they are income taxes paid on or with respect to the § 965(b) PTI.
37. Tax credits for E&P deficit foreign corporation are not deemed paid to the U.S. shareholder. Clarification is recommended to provide that these taxes are able to be used by the taxpayer, either as part of the § 965 inclusion or as part of future inclusions.

38. **NFTC Comments.** The NFTC comments on § 965 address many of the same issues at the NYSBA and The Chamber. NFTC commented on the PTI and specified E&P deficits, double counting of cash and the § 965(c) deduction, the foreign tax credit haircut, accounting changes, elections and entity classification elections issues and the overpayment of the transition tax issue.
39. The NFTC recommended the netting of short-term notes receivables and notes payables. Under Generally Accepted Accounting Principles (“GAAP”) accounts are netted to reflect the true cash position. Comparable rules should apply for § 965 purposes.
40. Short terms obligation that constitute U.S. property under § 956 should be excluded from the foreign cash position and U.S. obligations. The NFTC states that coordination with Subpart F is necessary to ensure that the § 965 is imposed only to extent that deferred foreign income has been reinvested in cash–equivalent assets.
41. The NFTC recommends that notional cash pools should be treated as intercompany loans for purposes of § 965. Notional cash pools should be treated the same as physical cash pools to prevent double counting.
42. To the extent a hovering deficit is treated as reducing the E&P of the DFIC, the NFTC recommends that the taxes should be treated as released pro rata in the same taxable year and be available to reduce the § 965 transition tax.
43. **NAM Comments.** The National Association of Manufacturers (“NAM”) also offered comments on the proposed § 965 regulations. The comments focused on the definition of cash, the double taxation issue, the treatment of PTI, consolidated return issues, the treatment of overpayments and foreign tax credit issues that can arise under § 960(b) when a deficit in one corporation is applied to reduce a DFIC’s E&P thus creating PTI..
44. **TEI Comments.** TEI also released comments on § 965. TEI comments addressed the publicly traded stock issue, the double counting issues and denial of foreign tax credits.
45. TEI recommends that the exclusion deferred foreign income should be extended to apply to dividends paid from SFCs to a related SFC and an unrelated foreign third party.
46. TEI requests guidance on two significant issues regarding hovering deficits. The first issue is whether hovering deficits reduce undistributed E&P for purposes of applying the deemed paid foreign tax credit. The second is whether taxes associated with a hovering deficit are added to the foreign income taxes. The NFTC recommended they be released pro rata, see above.

47. The final regulations should allow shareholders to determine gain resulting from the basis-shifting election on an aggregate rather than a share-by-share basis and to the extent gain is recognized it should be taxed at the rate of 15.5%. TEI suggests various alternatives for addressing certain mismatches between attributes of CFCs.
48. They also suggest that the final regulations should provide that foreign currency will be translated based on the average exchange rate not the spot rate.
49. TEI also recommends that refunds should be permitted for estimated tax payments. They also recommend that penalty protection rules for taxpayers who make a good faith effort to compute and pay the transition tax liability.
50. **SVTDG Comments.** The SVTDG recommends that Treasury provide guidance on the treatment of § 965(b) PTI for purposes of other Code provisions including §§ 1248, 951 and 956.
51. Since § 965(b) PTI can result in stranding of foreign taxes, the SVTDG recommends foreign tax credit rule modifications to address this issue.
52. Two recommendations are made on the double counting issues impacting E&P. The first recommendation that rather than shore up the double-counting rule, consider withdrawing the rule and relying on the § 965 elements rules to deter avoidance. The second recommendation is to provide an ordering rule.
53. Similar to other comments, SVTDG also recommends rules to prevent the double counting of cash in cash pooling, cash sweeps, revolving credit, and similar arrangements done in the ordinary course of business.
54. In the context of § 965 the SVTDG recommends relaxing § 960(a)(3) to allow it to apply to foreign income taxes paid or accrued by lower-tier foreign corporations with respect to distributions of § 965(a) PTI and § 965(b) PTI.
55. The SVTDG also recommends that the proposed regulations be modified to exclude PTI under §§ 959(c)(1) and (c)(2) from the definition of post-1986 E&P.

The § 965 Notices are discussed below for ease in following and understanding the new § 965 Proposed Regulation discussed in “B” above.

D. The First Notice: Mandatory Repatriation: Notice 2018-07: Double Counting Issues.

1. The first IRS Notice on the § 965 mandatory repatriation rules was released on December 29. It addresses the potential double-counting of cash and E&P when some CFCs are November 30 and others are December 31. The Notice provides much-needed relief in particular for companies that made § 898 one-month deferral elections.
2. It also addresses the calculation of cash position in situations in which one CFC owes money to another CFC as short-term loans or accounts payable. It treats all members of a consolidated group as a single U.S. shareholder for purposes of mandatory repatriation.
3. It reduces the § 986(c) impact of previously taxed income (“PTI”) arising from mandatory repatriation in proportion to reduced taxable income due to the deduction under § 965(c). It provides ordering rules and helpful examples of the interplay between regular Subpart F, mandatory repatriation Subpart F, PTI, § 956, and inter-CFC distributions. While helpful, query the authority for this modification?
4. To avoid double counting in situations in which specified foreign corporations have multiple inclusion years, regulations will provide that the aggregate foreign cash position taken into account in the first taxable year will equal the lesser of the United States shareholder’s aggregate foreign cash position or the aggregate of the § 965(a) inclusion amounts taken into account by the United States shareholders in that taxable year. The amount of the United States shareholder’s aggregate foreign cash position taken into account in any succeeding taxable year also will be its aggregate foreign cash position reduced by the amount of its aggregate foreign cash position taken into account in any preceding taxable year.
5. In an example, USP owns CFC1 which in turn owns CFC2. CFC1’s inclusion year ends December 31, 2017, and CFC2’s inclusion year ends November 30, 2018. The cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is \$200, with the result that USP has an aggregate foreign cash position of \$400. For 2017, USP would have to take into account CFC1’s § 965(a) inclusion amount of \$300, and for 2018, USP would have to take into account CFC2’s § 965(a) inclusion amount of \$300. Under the coordination rule, USP’s aggregate foreign cash position taken into account in 2017 is \$300, the lesser of USP’s aggregate foreign cash position (\$400) or the § 965(a) inclusion amount (\$300) that USP takes into account in 2017. The amount of USP’s aggregate foreign cash position taken into account in 2018 is \$100, USP’s aggregate foreign cash position (\$400) reduced by the amount of its aggregate foreign cash position taken into account in 2017 (\$300).

6. Another example contains the same basic facts except the cash position of CFC1 on each of December 31, 2015, December 31, 2016, and December 31, 2017, is \$100. The cash position of CFC2 on each of November 30, 2015, and November 30, 2016, is \$200. CFC1 has a § 965(a) inclusion amount. In determining its aggregate foreign cash position for its 2017 taxable year, USP may assume that its pro rata share of the cash position of CFC2 will be zero as of November 30, 2018 for purposes of filing its U.S. federal income tax return due on April 15, 2018 (or due on October 15, 2018, with extension).
7. Therefore, USP's aggregate foreign cash position is treated as \$300, which is the greater of (a) \$300, 50% of the sum of USP's pro rata shares of the cash position of CFC1 as of December 31, 2015, and December 31, 2016, and of the cash position of CFC2 as of November 30, 2015, and November 30, 2016, and (b) \$100, USP's pro rata share of the cash position of CFC1 as of December 31, 2017.
8. If USP's pro rata share of the cash position of CFC2 as of November 30, 2018, in fact exceeds \$200, which would result in USP's aggregate foreign cash position being greater than \$300, USP must make appropriate adjustments to reflect a higher aggregate foreign cash position, under future guidance to be issued by Treasury and the IRS.
9. The Notice says that net accounts receivables and short-term obligations between related specified foreign corporations might inflate the aggregate foreign cash position relative to the actual aggregate amount of liquid assets. For example, if one specified foreign corporation makes a short-term loan to another specified foreign corporation, the borrowing corporation might invest the proceeds of such financing in illiquid assets or might spend the cash on operating expenses.
10. The resulting intercompany receivable would be included in the U.S. Shareholder's aggregate foreign cash position, notwithstanding the fact that, if the specified foreign corporations were treated as a single corporation, the liquid assets of the specified foreign corporations would have been reduced by the amount of the borrowed proceeds. Accordingly, regulations will provide that any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation will be disregarded to the extent of the common ownership of such specified foreign corporations by the U.S. Shareholder.
11. Regulations will be issued that address the treatment of derivative financial instruments for purposes of measuring the cash position of a specified foreign corporation. Derivative financial instruments include notional principal contracts, options contracts, forward contracts, futures contracts, short positions in securities and commodities, and any similar financial instruments. These regulations will provide that the cash

position of any specified foreign corporation will include the fair market value of each derivative financial instrument held by the specified foreign corporation that is not a bona fide hedging transaction. The IRS will provide guidance in the future on identifying bona fide hedging transactions of specified foreign corporations that are not CFCs.

12. Double-counting or double non-counting earnings and profits arising from amounts paid or incurred (including certain dividends) between related specified foreign corporations that occur between measurement date also will be addressed in regulations. Regulations will clarify that the amount by which earnings and profits of a specified foreign corporation is reduced under § 965(d)(3)(B) as a result of a distribution made to a specified foreign corporation in the inclusion year may not exceed the amount by which the earnings and profits of the distribute corporation is increased as a result of the distribution.
13. In Example 1, USP owns CFC1 which owns CFC2. CFC1 and CFC2 each have 100u of earnings and profits (“E&P”). On November 3, 2017, CFC2 makes a deductible payment of 10u to CFC1. The payment does not constitute Subpart F income. Under the regulations to be issued, an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, § 965(a) earnings amounts of 200u. Example 2 is similar except instead of a 10u deductible payment CFC2 makes a 10u distribution.
14. In Example 3, the facts are the same as Example 1 except CFC2 does not make a deductible payment to CFC1, and, between measurement dates, CFC2 accrues gross income of 20u from a person that is not related to CFC2, and CFC1 incurs a deductible expense of 20u to a person that is not related to CFC1. CFC1 and CFC2 have, in the aggregate, § 965(a) earnings amounts of 220u. The § 965(a) earnings amounts, in the aggregate, are 20u greater than in Example 1, notwithstanding that CFC1 and CFC2 have, in the aggregate, earned no additional income. However, the additional 20u of § 965(a) earnings amount does not arise from an amount paid or incurred between specified foreign corporations that are related. The regulations to be issued will not adjust the aggregate § 965(a) earnings amounts of CFC1 and CFC2. This example illustrates that transactions with an unrelated party, such as a bank, can still adversely impact the § 965(a) cash earnings amount even if in the aggregate the transactions produce no additional income.
15. Example 4 has the same facts as Example 3, except that CFC2 also makes a deductible payment of 10u to CFC1 on November 3, 2017. Disregarding the intercompany deductible payment, CFC1 and CFC2 would have, in the aggregate, § 965(a) earnings amounts of 220u. Under regulations to be issued an adjustment would be made with the result that CFC1 and CFC2 would have, in the aggregate, § 956(a) earnings amounts of 220u.

E. The Second Notice: Mandatory Repatriation: Notice 2018-13: Electing a Method, Etc.

1. The Treasury Department and the IRS issued the second set of § 965 guidance in Notice 2018-13. The Notice describes the regulations that will be issued under § 965 and provides a number of helpful examples.
2. The Notice also announces the IRS's intent to update the Form 5471 instructions to make it clear that the downward CFC attribution rules (repeal of § 958(b)) do not create information return reporting obligations.
3. The Notice provides guidance on determining the status of a specified foreign corporation as a deferred foreign income corporation ("DFIC") or an E&P deficit foreign corporation. A specified foreign corporation that meets the definition of a DFIC is classified solely as a DFIC and not also as an E&P deficit foreign corporation.
4. In Example 1, USP owns all of the stock of FS, a foreign corporation. As of November 2, 2017, FS has an E&P deficit of 150u. As of December 31, 2017, FS has 200u of E&P. Because FS has accumulated deferred foreign income as of December 31, 2017, FS is a DFIC and is not an E&P deficit foreign corporation.
5. In Example 2, as of both November 2, 2017, and December 31, 2017, FS has 100u of previously taxed income and a deficit of 90u in E&P. As of both November 2, 2017, and December 31, 2017, FS has 10u of earnings and profits. Since FS does not have accumulated deferred foreign income greater than zero as of either measurement date, FS is not a DFIC. Since FS does not have a deficit in earnings and profits as of November 2, 2017, FS is not an E&P deficit foreign corporation. Accordingly, FS is neither a DFIC nor an E&P deficit foreign corporation.
6. The Notice provides an alternative method election for calculating earnings and profits based on an annualized earnings and profits amount. The Treasury Department and the IRS recognize that it may be impractical for taxpayers to determine E&P as of a measurement date that does not fall on the last day of a month. The term "annualized earnings and profits amount" means the amount equal to the product of two (the number of days after October 31, 2017, and on or before the measurement date on November 2, 2017) multiplied by the daily earnings amount.
7. In the example, FS has a calendar taxable year and as of October 31, 2017, FS has E&P of 10,000u, 3,040u of which were earned during the taxable year that includes October 31, 2017. The alternative method election is made. As of the close of October 31, 2017, 304 days have elapsed in the taxable year. FS's daily earnings amount is 10u (3,040u divided by 304), and FS's annualized earnings and profits amount is 20u (10u multiplied by

- 2). Accordingly, FS's E&P as of November 2, 2017, are 10,020u (10,000u plus its annualized earnings and profits amount of 20u).
8. The Treasury Department and the IRS also intend to issue regulations providing that, for purposes of determining a United States shareholder's pro rata share of the specified E&P deficit when there are multiple classes of stock. The specified E&P deficit is allocated first among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders.
 9. Consistent with the Conference Report, the Treasury Department and the IRS intend to issue regulations clarifying that all deficits, including hovering deficits, are taken into account.
 10. The newly issued regulations will provide that, for purposes of § 965(c)(3)(C), the term "accounts receivable" means receivables described in § 1221(a)(4), and the term "accounts payable" means payables arising from the purchase of property described in § 1221(a)(1) or 1221(a)(8) or the receipt of services from vendors or suppliers which have an initial term of less than 1 year (*see* Notice 2018-26 for the 1-year rule). Receivables that are treated as accounts receivable within the meaning of § 965(c)(3)(C)(i) will not also be treated as short-term obligations.
 - (a) Congress sought to measure liquidity. These A/R and A/P definitions do not seem right, for example, what about accounts receivable funded with debt?
 - (b) Notice 2018-26 (*infra*) helps here with a 1-year rule but more is needed.
 11. Regulations will be issued clarifying that for purposes of determining a specified foreign corporation's cash position, a loan that must be repaid on the demand of the lender (or that must be repaid within one year of such demand) will be treated as a short-term obligation, regardless of the stated term of the instrument.
 12. For purposes of determining the § 965(a) earnings amount of a specified foreign corporation, the regulations will provide that the accumulated deferred foreign income of each of the measurement dates must be compared in the functional currency of the specified foreign corporation. If the functional currency of a specified foreign corporation changes between the two measurement dates, the comparison must be made in the functional currency of the specified foreign corporation as of December 31, 2017, by translating the specified foreign corporation's earnings and profits as of November 2, 2017, into the new functional currency using the spot rate on November 2, 2017.

13. The Treasury Department and the IRS intend to issue regulations providing that the appropriate exchange rate under § 989(b) for translating the § 965(a) earnings amount will be the spot rate on December 31, 2017. The regulations will also provide that the spot rate on December 31, 2017, will apply for purposes of translating other amounts necessary for the application of § 965(b), including (1) translating a § 965(a) earnings amount into U.S. dollars in computing amounts described in § 965(b)(2)(A) and (B), (2) translating a specified E&P deficit into U.S. dollars in order to determine a U.S. shareholder's aggregate foreign E&P deficit under § 965(b)(3)(A), (3) translating a § 965(a) inclusion amount with respect to a DFIC (if such amount was reduced by an aggregate foreign E&P deficit under § 965(b)(1)) back into the functional currency of the DFIC for purposes of determining the previously taxed income of the DFIC, and (4) translating the portion of the U.S. dollar-denominated aggregate foreign E&P deficit allocated to a DFIC under § 965(b)(2) into the functional currency of the DFIC for purposes of determining its previously taxed income under § 965(b)(4)(A).
14. § 986(c). The regulations will also provide that, for purposes of § 986(c), foreign currency gain or loss with respect to distributions of previously taxed income described in § 959(c)(2) by reason of § 965 will be determined based on movements in the exchange rate between December 31, 2017, and the date on which such previously taxed earnings and profits are actually distributed.
15. In the Example, USP, a domestic corporation, owns all of the stock of CFC1, an E&P deficit foreign corporation with the "u" as its functional currency; CFC2, an E&P deficit foreign corporation with the "v" as its functional currency; CFC3, a DFIC with the "y" as its functional currency; and CFC4, a DFIC with the "z" as its functional currency. USP, CFC1, CFC2, CFC3, and CFC4 each have a calendar year taxable year. As of December 31, 2017, $1u = \$1$, $.75v = \$1$, $.50y = \$1$, and $.25z = \$1$. CFC1 has a specified E&P deficit of $100u$, CFC2 has a specified E&P deficit of $120v$, CFC3 has a § 965(a) earnings amount of $50y$, and CFC4 has a § 965(a) earnings amount of $75z$.
16. The § 965(a) earnings amount of CFC3 and CFC4 translated into U.S. dollars at the spot rate on December 31, 2017, is \$100 ($50y$ at $.50 = \$1$) and \$300 ($75z$ at $.25z = \$1$), respectively. For purposes of applying § 965(b), the specified E&P deficit of each of CFC1 and CFC2 translated into U.S. dollars at the spot rate on December 31, 2017, is \$100 ($100u$ at $1u = \$1$) and \$160 ($120v$ at $.75v = \$1$), respectively.
17. For purposes of applying § 965(b), USP's aggregate foreign E&P deficit of \$260 is allocated \$65 to reduce the amount that USP would otherwise take into account under § 951(a)(1) by reason of § 965 with respect to CFC3 ($\$260 \times (\$100/\$400)$) and allocated \$195 to reduce the amount that

USP would otherwise take into account under § 951(a)(1) by reason of § 965 with respect to CFC4 ($\$260 \times (\$300/400)$). After reduction under § 965(b)(1), the § 965(a) inclusion amount of USP with respect to CFC3 is \$35 ($\$100 - \65) and the § 965(a) inclusion amount of USP with respect to CFC4 is \$105 ($\$300 - \195). The previously taxed income of CFC3 and CFC4 resulting from the § 965(a) inclusion amounts included in gross income by USP, translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 17.5y ($\$35 \text{ at } .50y=\1) and 26.25z ($\$105 \text{ at } .25z=\1), respectively.

18. For purposes of determining the previously taxed income of each of CFC3 and CFC4 under § 965(b)(4)(A) as a result of the reduction to USP's § 965(a) inclusion amounts with respect to CFC3 and CFC4, the amounts of the aggregate foreign E&P deficit of USP are allocated to each of CFC3 and CFC4 under § 965(b)(2), which translated into the respective functional currencies of CFC3 and CFC4 at the spot rate on December 31, 2017, are 32.5y ($\$65 \text{ at } .50y=\1) and 48.75z ($\$195 \text{ at } .25z=\1), respectively.
19. The Treasury Department and the IRS intend to issue regulations providing that the cash position of a specified foreign corporation with respect to any cash measurement date must be expressed in U.S. dollars. In determining the cash position attributable to net accounts receivable, the amount of accounts receivables and accounts payables (in each case, if not otherwise denominated in U.S. dollars) must be translated into U.S. dollars at the spot rate on the relevant cash measurement date. The fair market value of assets described in § 965(c)(3)(B)(iii) must also be determined in U.S. dollars on the relevant cash measurement date.
20. The Treasury Department and the IRS intend to issue regulations that provide that the gain-reduction rule also applies to distributions received from a DFIC through a chain of ownership described in § 958(a).
21. In the Example, USP owns all of the stock of CFC1 with no E&P (or deficit), and CFC1 owns all the stock of CFC2, a DFIC. USP is a calendar year taxpayer. CFC1 and CFC2 have inclusion years that end on November 30, 2018. The functional currency of CFC1 and CFC2 is the U.S. dollar. USP's adjusted basis in the stock of CFC1 is zero, and CFC1's adjusted basis in the stock of CFC2 is zero. On January 1, 2018, CFC2 distributes \$100 to CFC1, and CFC1 distributes \$100 to USP. USP has a § 965(a) inclusion amount of \$100 with respect to CFC2. CFC2 has no other earnings and profits. The amount of gain that USP would otherwise recognize with respect to the stock of CFC1 under § 961(b)(2) and the amount of gain that CFC1 would otherwise recognize with respect to the stock of CFC2 under § 961(c) for purposes of determining CFC1's Subpart F income is reduced (but not below zero) in each case by \$100, USP's § 965(a) inclusion amount with respect to CFC2.

22. § 958(b). The Treasury Department and the IRS have determined that, in light of the change to the constructive ownership rules in § 958(b), further study is necessary to determine whether it is appropriate for the source of income described in § 863(b) and (e) to be determined by reference to the status of the recipient as a CFC. Accordingly, taxpayers may determine whether a foreign corporation is a CFC without regard to the repeal of § 958(b)(4) pending further guidance (which will be prospective).
23. The IRS intends to amend the instructions for Form 5471 to provide an exception from Category 5 filing for a U.S. person that is a U.S. shareholder with respect to a CFC if no U.S. shareholder (including such U.S. person) owns, within the meaning of § 958(a), stock in such CFC, and the foreign corporation is a CFC solely because such U.S. person is considered to own the stock of the CFC owned by a foreign person under § 318(a)(3).

F. The Third Notice: Notice 2018-26: Yet More New Anti-Avoidance Rules.

1. The IRS and Treasury released its third set of guidance on the new mandatory repatriation tax under § 965 in Notice 2018-26. The Notice provides anti-avoidance rules and addresses a number of various issues including the treatment of accrued foreign taxes, rules regarding cash measurement dates, elections, the treatment deduction for AMT purposes, and a penalty waiver.
2. Under the anti-avoidance rules, a transaction will be disregarded if it occurs on or after November 2, 2017; is undertaken with a principal purpose of reducing § 965; and the transaction reduces the § 965 tax. A transaction is considered to reduce the § 965 tax if it (i) reduces the § 965(a) inclusion amount, (ii) reduces the aggregate foreign cash position, or (iii) increases the amount of foreign income taxes deemed paid under § 960. In addition, the Notice establishes per se transactions which are automatically treated as undertaken with a principal purpose of reducing § 965.
3. Certain transactions are presumed to be undertaken with a principal purpose of reducing § 965 and may be rebutted only if the facts and circumstances clearly establish otherwise. To assert a rebuttable presumption a disclosure statement must be filed with the income tax return. This is excessive. Taxpayers will need to review every transaction. A failure to disclose a transaction could result in an automatic trigger of the anti-avoidance rules.
4. A cash reduction transaction is presumed to be undertaken with a principal purpose of reducing § 965. The presumption does not apply to a cash reduction transactions that occur in the ordinary course of business. A “specified distribution” is a per se transaction if (i) at the time of the

distribution, there was a plan or intention to transfer, cash, accounts receivable, or cash equivalent assets to any specified foreign corporation, or (ii) the distribution is a non pro rata distribution to a related foreign person.

5. The specified distribution definition is overbroad. A cash distribution of \$1 million could be viewed as tainted if the U.S. shareholder has a separate and unrelated plan to transfer \$100 to another controlled foreign corporation (“CFC”) in the ordinary course of business. The definition should be rewritten to provide that a distribution will be a specified distribution only to the extent of the plan to retransfer cash or equivalents to a CFC and only if the distribution and the retransfer are related.
6. An E&P reduction transaction is presumed to be undertaken with a principal purpose of reducing § 965, unless it occurs in the ordinary course of business. An E&P reduction transaction is a “specified transaction” that is a per se transaction if it (i) is a § 331 complete liquidation; (ii) a sale or dispositions of the stock; or (iii) a distribution that reduces E&P pursuant to § 312(a)(3). This per se rule picks up ordinary course transactions, for example, a simple § 351 drop-down of stock would be covered.
7. A pro rata share transaction is also presumed to be undertaken with a principal purpose of reducing § 965.
8. An internal group transaction will be treated as a per se transaction if, immediately before or after the transfer, the transferor and the transferee of the stock are members of an affiliated group.
9. The Notice provides one example of the anti-avoidance rules. In the example, a foreign corporation owns a U.S. corporation, which owns a foreign subsidiary. On January 2, 2018, the U.S. corporation transfers all of its foreign subsidiary stock to the foreign corporation for cash. The next day the foreign subsidiary makes a distribution. The U.S. corporation treats the transaction as a taxable sale and claims a dividends received deduction. The Notice states that the transfer of stock is a pro rata share transaction and an internal group transaction. Therefore, this transaction is treated per se as being undertaken with a principal purpose of reducing § 965. Thus, the transfer will be disregarded and the foreign subsidiary earnings are determined as if the U.S. corporation still owned the stock.
10. § 958(b). The Notice provides helpful but limited relief from downward attribution when the tested partner owns less than 5% of the partnership capital and profits. The downward attribution relief should be broader in light of the legislative history stating that Congress generally did not intend the repeal of § 958(b)(4) to cause a foreign corporation to be treated as a CFC with respect to an unrelated U.S. shareholder.

11. The Notice clarifies the cash measurement date rules when the specified foreign corporation is acquired, disposed of, or ceases to exist between measurement dates.
12. FTCs. The Notice also provides some very helpful relief from the rule that foreign income taxes accrue only on the last day of the foreign tax year. Absent this relief, E&P measured on November 2, 2017 might include 10 months (and two days) of 2017 earnings but no 2017 foreign income taxes.
13. Treasury and the IRS also intend to issue regulations providing that any method of accounting changes will be disregarded for purposes of determining § 965 if the change reduces the § 965 liability. These regulations will not apply if the Form 3115 change request was filed before November 2, 2017.
14. Any entity classification election under Treas. Reg. § 301.7701-3 filed on or after November 2, 2017, will also be disregarded if the election reduces the § 965 liability. This rule will apply even if the entity classification election was effective before November 2, 2017.
15. The change in method of accounting and entity classification rules will apply regardless of whether they are made with a principal purpose of reducing § 965. The automatic denial regardless of purpose is overbroad, and not reciprocal. Transactions are disregarded when they reduce § 965 but are given full effect when they increase § 965.
16. The IRS intends to issue forms, publications, regulations or other guidance that will specify the documentation required to demonstrate that net accounts receivable, actively traded property, and/or short-term obligations may be excluded from the shareholder's aggregate foreign cash position under § 965(c)(3)(D) because they have already been taken into account.
17. The Notice provides rules for the application of § 965 to a domestic pass-through entity and its U.S. owners, including who may make § 965 elections. The § 965(a) inclusion and the § 965(c) deduction should be determined at the level of the domestic pass-through entity and must be allocated to in the same proportion. Any § 965(c) deduction will be determined separately from the owner's share of the § 965(a) amount and § 965(c) deduction of the domestic pass-through entity. With respect to the elections under § 965(h), (m), and (n), the regulation will allow a domestic pass-through owner to make these elections regardless of whether the domestic pass-through owner is a U.S. shareholder. For purposes of determining a domestic pass-through owner's net tax liability under § 965, the domestic pass-through owner will be treated as a U.S. shareholder.

18. Treasury and the IRS intend to issue regulations clarifying that a domestic pass-through owner who is an individual and is also a U.S. shareholder may make a § 962 election with respect to the individual's share of the § 965(a) inclusion amount. However, an individual who is not a U.S. shareholder will not be permitted to make the election. The regulations will also clarify that the same principles apply to Subpart F inclusion other than by reason of § 965.
19. Treasury and the IRS intend to issue regulations providing that, if an election is made under § 965(n), then, pursuant to § 965(n)(1)(A), the amount of an NOL for the year will be determined without taking into account as gross income the amount described in § 965(n)(2). The regulations will also clarify that the election will be treated as made with respect to both the amount of the NOL for the year and the NOL carryovers and carrybacks.
20. Treasury and the IRS intend to issue regulations providing that the § 965(c) deduction will not be treated as an itemized deduction, and thus will not be subject to the 2% floor or the AMT.
21. The regulations will provide that “accounts receivable” and “accounts payable” will only include receivables and payables with an initial term of less than one year.
22. The Notice provides that the IRS will waive underpayment penalties under §§ 6654 and 6655 with respect to any net tax liability under § 965 for those taxpayers who do not elect to pay their net tax liability under § 965 in installments.

G. CFC Tax Year-End Changes: More Anti-Avoidance Rules.

1. In Rev. Proc. 2018-17 the IRS modifies the circumstances under which it will grant approval of accounting period changes. The revenue procedure was issued pursuant to § 965(o) to prevent the avoidance of the purposes of § 965 through changes in the taxable years of certain specified foreign corporations. The Revenue Procedure states that a § 965 specified foreign corporation with a taxable year ending on December 31, 2017, could avoid the purposes of § 965 by changing its taxable year. For example, if a calendar year deferred foreign income corporation (“DFIC”) elected a taxable year closing on November 30, the election could defer by as much as 11 months a United States shareholder's inclusion with respect to the DFIC under § 965. Further, the election could, depending on the facts, reduce the amount of the tax liability of a United States shareholder of the DFIC by reason of § 965, including through the reduction of the post-1986 earnings and profits of the DFIC. The revenue procedure applies to a § 965 specified foreign corporation seeking to change its taxable year that ends on December 31, 2017.

2. Under the revenue procedure, a request to change the annual accounting period of a specified foreign corporation (as defined in § 965(e)) will not be approved if:
 - (a) The specified foreign corporation's taxable year (determined without regard to the requested change) ends on December 31;
 - (b) If the requested change were permitted, the first effective year of the corporation would begin on January 1, 2017, and would end on a date before December 31, 2017; and
 - (c) The specified foreign corporation has one or more United States shareholders that must include an amount in gross income under § 951(a)(1) by reason of § 965 with respect to the specified foreign corporation or any other specified foreign corporation (with such amount determined without regard to the requested change)."

H. NYSBA Report.

1. The NYSBA report requests immediate guidance to fill the interpretative gaps in § 965 in a manner consistent with the legislative intent and to make it clear that the income is subject to tax only once. The NYSBA requests that for specified foreign corporations ("SFC") that were not either CFCs or § 902 corporations before should be able to determine deferred E&P and cash positions based on financial statements and statements of retained earnings filed with a governmental entity or audited by an independent accountant.
2. The report requests guidance regarding the measurement of E&P and deficits with respect to: mid-year measurement dates; sales, redemptions and distributions during the transition year; application of E&P deficit rules to SFCs with PTI and E&P deficits; hovering deficits and related foreign income taxes; and potential double counting of earnings and profits of SFCs with inclusion years ending November 30, 2018.
3. Guidance is also requested regarding the measurement of cash position including: notional cash pooling arrangements; the definition of accounts payable; and the treatment of non-corporate entities as SFCs.
4. The NYSBA requests guidance regarding previously taxed income ("PTI") and basis adjustments including a PTI ordering rule and guidance on the timing of basis adjustments. The report warns that PTI adjustments in excess of basis increases may trap earnings and profits.
5. The report recommends that guidance be issued clarifying that distributions made to a U.S. shareholder during the inclusion year are within the scope of the effective date provisions of the Notices and any regulations promulgated pursuant thereto.

6. Guidance is requested that provides that, if a taxpayer makes the election under § 965(n)(1) with respect to a taxable year, the amount described in § 965(n)(2) shall not be taken into account in determining the amount of the net operating loss under § 172 of such shareholder for such taxable year.
7. The NYSBA also requests guidance providing that a consolidated group is permitted to make an election under § 965(n), which election would exclude the impact of § 965 on the members of the consolidated group from the calculation of the CNOL and in determining the amount of consolidated taxable income which may be reduced by a CNOL carryover or carryback.
8. Guidance is also requested on the election to pay the tax in installments, the treatment of inclusions by regulated investment companies, and the repeal of § 958(b)(4).

I. US Chamber of Commerce Comments Regarding Notice 2018-26.

1. The U.S. Chamber of Commerce highlighted a number of issues and provided suggested solutions and feedback to the IRS regarding Notice 2018-26. Notice 2018-26 is the third notice addressing the repatriation tax under § 965, G. above. Notice 2018-26 established a number of antiavoidance rules and per se transactions. A number of the Chamber's comments provide solutions to limit the application of the Notice's inflexible and draconian antiabuse rules. The Chamber recommends limiting the reduction of the § 965 tax liability to instances in which there is a net decrease in the U.S. tax liability of the U.S. shareholder and/or related parties, such that if a transaction reduces a U.S. shareholder's § 965 tax liability but creates an offsetting increase in other U.S. tax liability of, or in the total amount of income included by, the U.S. shareholder or related parties, the transaction is not subject to the anti-avoidance rule.
2. The Chamber suggests that Treasury should consider creating an exception to the application of the antiabuse rule for transactions that would otherwise result in a de minimis reduction in § 965 tax liability in order to reduce the administrative burden of calculating the § 965 tax liability.
3. For ordinary course transactions, the Chamber recommends an exemption from the antiavoidance rules for cash reduction transactions, E&P reduction transactions and pro rata share transactions.
4. The Chamber recommends that accounting method changes from an impermissible method to a permissible method should not be subject to the antiavoidance rule. They also recommend that a principal purpose test

apply to all other accounting method changes and entity classification elections.

J. § 965 Overpayments.

1. On August 2, 2018, in PMTA 2018-016, the IRS discussed § 965(h) overpayments and reiterated that any 2017 payments or estimated tax payments under § 965(h) that exceeded the net income tax liability described under § 965(h)(6)(A)(ii), are not eligible for a refund unless and until the amount of payments exceeds the entire unpaid 2017 income tax liability, including all amounts to be paid in installments under § 965(h) in subsequent years.
2. This issue was also discussed in the IRS questions and answers (“Q&As”) relating to I.R.C. § 965 answer number 14. Answer 14 provides that any excess amount paid is applied to the “next successive annual installment (due in 2019), and to the extent such excess exceeds the amount of that installment due, then to the next such successive annual installment (due in 2020), etc.” Taxpayers expressed concerns with the legal basis for this answer.
3. The Service states that its legal authority to make a credit or refund is in § 6402. By its terms, the IRS states § 6402(a) does not grant the Service the legal authority to credit or refund any amount except to the extent that an overpayment exists with respect to a liability, citing *Minihan v. Commissioner*, 138 T.C. 1 (2012). The Associate Chief Counsel also states in the memorandum that § 6402(b) does not authorize the Service to apply any amount as a credit to the succeeding year’s estimated income tax except to the extent that such amount constitutes an overpayment. I.R.C. § 6402(a) and (b).
4. Accordingly, the memorandum states that an overpayment under § 6402(a) does not exist with respect to a 2017 income tax liability unless and until the entire liability is fully paid, including any amount of that liability that is subject to an election to pay that income tax liability in installments under § 965(h). Absent an overpayment of the entire tax liability for the 2017 tax period, the Service cannot issue a credit or refund under § 6402(a) with respect to the 2017 tax period.

K. Section 965 and Overpayments.

1. A number of commentators including the U.S. Chamber of Commerce have asked Treasury and the IRS to revise the guidance on § 965 and overpayments. The Chamber of Commerce stated that requiring taxes (including estimated taxes) to be applied in full against the transition tax liability rather than as a refund or a credit against the 2018 tax liability is contrary to the § 965 statutory language and the legislative intent.

2. On March 13, 2018, the IRS posted § 965 guidance including a question and answer section (Q&A) on its website. The Q&A stated that the first § 965 installment would be paid separately indicating that the § 965 liability payment would be separate from regular tax liabilities and that the estimated taxes would not be applied against the transition tax. Then one month later, the IRS issued additional guidance on the § 965 Q&A website with two new questions and answers in 13 and 14 that abandoned that approach. The abandonment of the separate approach for § 965 was announced only ten days before tax payments were due.
3. The Chamber pointed out that taxpayers often overpay their tax liability and that as a result taxpayers will consistently have overpayments that are allocated to the § 965 installment payments resulting in a significantly shortened installment period and an acceleration of millions of dollars of tax payments. The Chamber stated this is not consistent with the clear reading of § 965(h) and (i) or with the policy Congress intended by including an election to make installment payments over the prescribed eight-year period. Treating overpayments as satisfying the transition tax liability is inconsistent with the policy to allow the payments over eight years.
4. The IRS recently released a Chief Counsel Memorandum (“CCM”) on August 2, 2018 reiterating that taxes (including estimated taxes) will be applied in full against the transition tax liability rather than as a refund or a credit and stated that the IRS position was based on §§ 6402 and 6403.
5. The Chamber challenges the IRS’s position in the CCM and stated that the tax overpayment is not a payment of the installment under § 6403. Taxpayers who overpaid their 2017 taxes did not overpay the § 965 installment tax; they overpaid their 2017 net income tax liability – which by definition excludes the § 965 liability for the year. Thus, there is no overpayment of the tax payable as an installment under § 6403. Furthermore, when a timely deferral election is made, only the first installment is technically due with the 2017 return.
6. Under IRC § 6402(a), the IRS can either refund overpayments or credit them against 2018 estimated taxes.
7. The Chamber also stated that it is very concerned that the IRS guidance is functionally a new tax regulation that was issued with immediate effect and without following the applicable rules of the Administrative Procedure Act. The Chamber believes the guidance is a legislative rule subject to notice and comment and that it should have been incorporated into the proposed regulations.
8. Since TCJA was enacted at the very end of the year, the Chamber notes that, taxpayers preparing their 2017 extension payments had to minimize

potential underpayment penalties by being overly cautious. The IRS issued the guidance regarding the application of overpayments to the transition tax when most taxpayers had already scheduled their electronic fund transfers punishing taxpayers for acting responsibly. The Chamber stated that taxpayers who are in an overpayment position are placed at a competitive disadvantage to taxpayers who are in an underpayment position as a result of the new guidance on § 965 and overpayments.

L. More IRS Guidance: § 965 Frequently Asked Q&A.

1. The IRS published Frequently Asked Questions and Answers (“FQ&A”) addressing the transition tax under § 965 for purposes of filing 2017 tax returns with amounts included under § 965.
2. The FQ&A states that amounts required to be reported on a 2017 tax return should be reported on the return as reflected in the table included in the Appendix labeled FQ&A2. A taxpayer with 2017 § 965 income is required to include an IRC 965 Transition Tax Statement, signed under penalties of perjury and, in the case of an electronically filed return, in Portable Document Format (.pdf) with a filename of “965 Tax.” A model statement is included in an Appendix labeled FQ&A3. The IRC 965 Transition Tax Statement must include the following information:
 - The total amount required to be included in income under § 965(a).
 - The aggregate foreign cash position.
 - The total deduction under § 965(c).
 - The deemed paid foreign taxes with respect to the total § 965(a) amount.
 - The disallowed deemed paid foreign taxes pursuant to § 965(g).
 - Any total net tax liability under § 965 (as determined under § 965(h)(6), without regard to whether such paragraph is applicable), which will be assessed.
 - The amount of any net tax liability under § 965, the payment of which has been deferred, under § 965(i) of the Code.
 - A listing of any elections under § 965 or Notice 2018-13.
3. Adequate records must be kept supporting the § 965(a) inclusion amount, deduction under § 965(c), and net tax liability under § 965, as well as the underlying calculations of these amounts.

4. An election with respect to § 965 of the Code must be made by the due date (including extensions) for filing the return for the relevant year. However, even if an election is made under § 965(h) of the Code to pay a net tax liability in installments, the first installment must be paid by the due date (without extensions) for filing the return for the relevant year.
5. A domestic partnership, S corporation, or other passthrough entity should attach a statement to its Schedule K-1s, that includes the following information for each deferred foreign income corporation for which such passthrough entity has a § 965(a) inclusion amount:
 - The partner's, shareholder's, or beneficiary's share of the partnership's, S corporation's, or other passthrough entity's § 965(a) inclusion amount.
 - The partner's, shareholder's, or beneficiary's share of any of the partnership's, S corporation's, or other passthrough entity's deduction under § 965(c).
 - Information necessary for a domestic corporate partner, or an individual making an election under § 962, to compute its deemed paid foreign tax credits with respect to its share of the partnership's, S corporation's, or other passthrough entity's § 965(a) inclusion amount, if applicable.
6. Two separate payments need to be made, one payment reflecting tax owed without regard to § 965, and another separate payment reflecting tax owed resulting from § 965 (the 965 Payment). Both payments must be paid by the due date of the applicable return (without extensions).
7. The FQ&A seems to have addressed certain issues by treating the § 965(c) deduction as essentially an exclusion. The FQ&A indicates that individuals should include the net amount (gross inclusion under § 965(a) less the § 965(c) deduction) as other income on Line 21. It suggests that, for individuals who make the § 962 election, the § 11 tax may be determined by taking into account a corporate-level § 965(c) deduction.

M. Section 965: IRS Publication 5292. The Treasury and the IRS released Publication 5292, on "How to Calculate Section 965 Amounts and Elections Available to Taxpayers," for use in preparing 2017 tax returns. The report discusses the Tax Return/Mandatory Attached Statement and provides seven worksheets to assist in calculating the § 965 amounts: Worksheet A is for calculating the Section 965(a) inclusion amount; Worksheet B is for calculating the deferred foreign income corporation's E&P; Worksheet C is for calculating the aggregate foreign E&P deficit; Worksheet D is for calculating the aggregate foreign cash position; Worksheet E is for calculating the aggregate cash position detail; Worksheet G is for calculating the foreign taxes deemed paid by the

domestic corporation; and Worksheet H is for calculating the disallowance of FTC and amounts reported on Forms 1116 and 1118. The publication also discusses what elections can be made and who can make an election, when must an election must be made, and how elections are made.

N. Late Filing Relief.

1. The IRS has announced that it will waive certain 965 transition tax late-payment penalties. IR-2018-131 (June 4, 2018). The details of the recently announced relief is contained in three new IRS FAQs posted on the IRS's tax reform page, F. above. See <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns>. The three new questions and answers are numbers 15, 16, and 17 and the three new Q&As supplement the fourteen existing Q&As.
2. The first new Q&A is in number 15 and it provides that the IRS will waive the estimated tax penalty for taxpayers who improperly applied a 2017 calculated overpayment to their 2018 estimated tax if the required estimated tax payments are made by June 15, 2018. This relief applies only to taxpayers whose first required 2018 installment was due on or before April 18, 2018. If the conditions for relief are satisfied and the IRS sends an underpayment notice, the FAQ states that the taxpayer should request abatement in accordance with the provisions in the FAQs and the Form 2210 and 2220 instructions.
3. The second and third new Q&As deal with individuals. For individuals who missed the April 18, 2018, deadline for making the first annual installment payment, the IRS will waive the late-payment penalty if the installment is paid in full by April 15, 2019. Absent this relief, the remaining installments would have become due immediately. Individuals who already filed a 2017 return without the installment election can still make the election if the amended Form 1040 is filed by Oct. 15, 2018.

O. Section 965. Notice 2018-78

1. In Notice 2018-78, Treasury and the IRS announced that the due date will be extended for certain § 965 basis elections, the rules for determining consolidated aggregate foreign cash position will be revised, and additional time would be allowed for taxpayers affected by Hurricane Florence.
2. Prop. Treas. Reg. § 1.965-2(f)(2) allows a § 958(a) U.S. shareholder to elect to make certain basis adjustments with respect to each deferred foreign income corporation ("DFIC") and each E&P deficit foreign corporation. Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(B)(1)(i) provides that the basis election must be made no later than the due date (taking into account extensions, if any) for the § 958(a) U.S. shareholder's return for

the first taxable year that includes the last day of the last taxable year of a deferred foreign income corporation or E&P deficit foreign corporation that begins before January 1, 2018. If the due date occurred before September 10, 2018, Prop. Treas. Reg. § 1.965-2(f)(2)(iii)(B)(1)(ii) (the “transition rule”) provides that the basis election must be made by October 9, 2018.

3. Treasury and the IRS have determined that requiring taxpayers to make a binding basis election before the proposed regulations are finalized would be too onerous for taxpayers. Accordingly, the final regulations will provide that the transition rule will apply with respect to returns due (determined with regard to any extension) before the date that is 90 days after the date that the final regulations are published and that in such cases the basis election must be made no later than 90 days after the publication of the final regulations in the Federal Register.
4. In addition, the final regulations will provide that if a basis election was made on or before the date the final regulations are published, the basis election may be revoked no later than 90 days after the publication of the final regulations in the Federal Register. Relevant tax returns must be filed consistently with an election that has been made and not revoked.
5. The Notice also advises that to prevent the overstatement of the aggregate foreign cash position, the final regulations will provide that all members of a consolidated group that are § 958(a) U.S. shareholders of a specified foreign corporation are also treated as a single § 958(a) U.S. shareholder for purposes of Prop. Treas. Reg. § 1.965-3(b).
6. Finally, taxpayers affected by Hurricane Florence whose § 965 elections or transfer agreements are due on or after September 7 and before January 31, 2019, are given additional time to file elections or transfer agreements and have until January 31, 2019. A Hurricane Florence affected taxpayer is a taxpayer whose principal residence or principal place of business was located in a Hurricane Florence covered disaster or whose records necessary to meet its obligation were maintained in such a covered disaster area, or in the case of a transfer agreement, a taxpayer who intends to enter into a transfer agreement with such a taxpayer.

P. Section 965 Reporting Special Update.

1. The IRS announced a special update on § 965 in the Question and Answers website about reporting related to § 965. The announcement states that the proposed regulations in § 1.965-7 call for certain transfer agreements to be filed by October 9, 2018 in accordance with rules provided in forms, instructions, or other guidance.

2. The IRS is aware that taxpayers need more guidance on where and how to submit these agreements and plans to provide further guidance in the near future. Transfer agreements filed in accordance with this future guidance will still be considered timely filed notwithstanding the October 9, 2018 date mentioned in the proposed regulations.

III. GILTI.

A. GILTI.

1. Under new § 951A, GILTI must be included in income each year by CFCs' U.S. shareholders. For purposes of these rules, net deemed intangible income return is the excess (if any) of the net CFC tested income over each shareholder's net deemed tangible income return.
2. Net deemed tangible income return is the excess of 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC in which it is a U.S. shareholder over the amount of interest expense taken into account in determining its net CFC tested income for the tax year, to the extent that the interest income attributable to the interest expense is not taken into account in determining its net CFC tested income.
3. Under section 951A(f) the inclusion is treated "in the same manner" as Subpart F income for purposes of applying a number of Code provisions.
4. The Conference Report says the conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return and QBAI) to minimize tax under the new provision be disregarded. For example, the conferees expect the IRS to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under amended § 965 but before the final tax year for which new § 951A applies if these transactions are undertaken to increase a CFC's QBAI.
5. A special deductions relating to GILTI is set forth in IRC § 250.
6. Credits for foreign taxes "properly attributable to" GILTI are allowed under § 960 but subject to an 80% cap. Section 960 no longer is a multi-year pooling provision. The income and the taxes are included in a separate § 904(d) foreign tax credit basket. Excess credits cannot be carried back or forward.
7. Under a 21% corporate tax rate and as a result of the deduction for FDII and GILTI in § 250, the effective tax rate on FDII is 13.125% and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5% for taxable years beginning after December 31, 2017 and before

January 1, 2026. Since only a portion (80%) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate with respect to GILTI at which no residual U.S. tax is owed by a foreign corporation is 13.125%.

8. If the foreign tax rate on GILTI is 0%, then the U.S. residual tax rate on GILTI is 10.5%. Therefore, as foreign tax rates on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5% and 13.125%. At foreign tax rates greater than or equal to 13.125%, there is no residual U.S. tax owed on GILTI, so the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

B. GILTI Issues.

1. Section 951A provides for an inclusion by a U.S. shareholder of its CFC's tested income for the year less its net deemed tangible income return for the year.
2. Tested income excludes among other things the CFC's Subpart F income and high-taxed income under § 954(b)(4), and allows the CFC's deductions properly allocable to the income under § 954(b)(5).
3. Section 951A(f) treats GILTI as Subpart F for a number of enumerated Code sections.
4. Section 904(a) does not provide a special limitation rule for GILTI (discussed in "D" below), but § 904(d) provides for a separate basket for "any amount includible in gross income under § 951A (other than passive category income)."
 - (a) Questions have arisen as to whether a CFC has a GILTI basket, or whether this basket only exists at the U.S. parent company level.
 - (b) Another issue involves the § 78 gross up related to GILTI: is this amount included in the § 904(g) GILTI basket? Note that the gross-up is without the 80% "haircut."
 - (c) A third issue involves § 986(c)'s currency gain or loss on distributions of PTI: are these amounts included in the § 904(d) GILTI basket?
 - (d) A fourth issue involves royalties and interest paid by a CFC to the U.S. parent company. Do the CFC look-through rules apply to make the royalty or interest income GILTI-basket income? They shouldn't.
 - (e) Note the obvious tax planning opportunity: Subpart F income is taxed at the U.S. parent company level (21% rate) separately from

GILTI income (10.5%) but subject to separate foreign tax credit rules.

5. Section 960(d) provides for a deemed paid foreign tax credit from “taxes properly attributable to tested income” regarding GILTI amounts included in income under § 951A, with an 80% limit on the foreign tax. *See* Treas. Reg. § 1.904-6, which offers some guidance but much more is needed.

- C. The scope and purpose of the GILTI rules is set forth in the legislative history conference report states:

“Under a 21% corporate tax rate and as a result of the deduction for FDII and GILTI, the effective tax rate on FDII is 13.125% and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5% for taxable years beginning after December 31, 2017 and before January 1, 2026. Since only a portion (80%) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate with respect to GILTI at which no residual U.S. tax is owed by a foreign corporation is 13.125%. If the foreign tax rate on GILTI is 0%, then the U.S. residual tax rate on GILTI is 10.5%. Therefore, as foreign tax rates on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5% and 13.125%. At foreign tax rates greater than or equal to 13.125%, there is no residual U.S. tax owed on GILTI, so the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.”²

- D. Subpart F High-Taxed Income After the Tax Reform Act.

1. Section 954(b)(4) provides an exception from Subpart F for income subject to high foreign taxes. Use of this provision is elective. If the election is made, Subpart F income does not include amounts that otherwise would be Subpart F income provided the taxpayer establishes that the income is subject to an effective rate of income tax imposed by a foreign country greater than 90% of the maximum rate of tax specified in § 11. CFCs will have a lot more income that qualifies under § 954(b)(4) following enactment of the new rules.
2. GILTI includes generally all of a CFC’s income for a particular year in excess of a minor markup on the CFC’s tangible assets, with the exceptions of Subpart F income and income that would be Subpart F income but which is excluded by reason of § 954(b)(4).
3. Thus, if the high-tax exclusion election is made, the high-taxed income will not be included as Subpart F income under the GILTI rules nor will it be Subpart F income under the general Subpart F rules. Foreign tax credits on that income will remain in the CFC and will not be available for

² Conf. Report at p. 498.

crediting in the U.S. A distribution of those earnings, after exhausting the CFC's large amounts of unrelated previously taxed income, will be subject to § 245 and the foreign tax credits cannot be claimed.

4. If the high-tax exclusion election is not made, the income will be taxed as Subpart F income under the general Subpart F rules and will bring with it the high foreign tax credits. Assuming the income is general-basket income (or passive-basket income "kicked out" into the general-basket) those credits will be in the general-basket and available to the U.S. taxpayer for use in connection with other general-basket foreign-source income, if any.
5. Thus, while in the past taxpayers sometimes faced a decision whether to make the high-tax exclusion election, the decision whether to make that election going forward is further complicated (or perhaps simplified) under the new tax rules.

E. Section 904: Ring Fence Needed.

1. An important new regulation is needed to coordinate § 904(a) with the GILTI rules.
2. The premise of GILTI is that when non-U.S. tax is 13.125% or higher, there should be no additional U.S. tax but that this isn't true if § 904 requires interest and stewardship expenses to be allocated against the stock of CFCs for purposes of GILTI. A clarification that the U.S. parent company's interest and stewardship expenses, for example, are not allocated to GILTI when the foreign tax rate is 13.125% or higher.
3. A number of commenters have commented similarly, for example, the U.S. Chamber of Commerce and Illinois Tool Works.
4. The Tax Reform Act's Conference Committee Report states (as also set forth above):

“Under a 21% corporate tax rate and as a result of the deduction for FDII and GILTI, the effective tax rate on FDII is 13.125% and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5% for taxable years beginning after December 31, 2017 and before January 1, 2026. Since only a portion (80%) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate with respect to GILTI at which no residual U.S. tax is owed by a foreign corporation is 13.125%. If the foreign tax rate on GILTI is 0%, then the U.S. residual tax rate on GILTI is 10.5%. Therefore, as foreign tax rates on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5% and 13.125%. At foreign tax rates greater than or equal to 13.125%, there is no

residual U.S. tax owed on GILTI, so the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.”³

5. Thus, it’s pretty clear what Congress intended regarding GILTI: That there be a direct correlation between the foreign tax rate and the GILTI U.S. tax rate.
6. The issue arises under § 904(a), which was not modified or conformed to coordinate with the new GILTI rules in the recent tax reform legislation. It states that “The total amount of credit taken under § 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer’s taxable income from sources without the United States (but not in excess of the taxpayer’s entire taxable income) bears to his entire taxable income for the same taxable year.”
7. Section 904(a) implicates the expense allocation rules of Treas. Reg. §§ 1.861-8 et seq. As noted, § 904(a) does not mention or take into account the new GILTI provisions. If literally applied to the new GILTI rules in calculating the relevant foreign tax credit, the legislative history referred to above would be rendered meaningless. The legislative history clearly expresses the intent of Congress that there is a direct correlation between the foreign tax rate and the U.S. GILTI tax rate. If expenses are allocated to GILTI income for purposes of § 904, that correlation would be lost and many taxpayers would be in FTC limitation below 10.5% in their GILTI basket.
8. Obviously, a regulation is needed to coordinate the § 904(a) rules and the new GILTI provisions to effect the clear statements of intent in the legislative history regarding the GILTI rules. A “ring fence” approach would solve the issue. This could be done without the need for any legislative correction: § 864(e)(7)(G) authorizes Treasury and the IRS to issue guidance to carry out the purposes of the new GILTI provisions as described in the Tax Reform Act’s legislative history.
9. We said above in discussing the Tax Act’s international provisions that the Treas. Reg. § 1.861-8 allocation and apportionment rules for allocating interest expense, R&D, and so forth to foreign-source income and baskets will need to be revised to account for these new rules. We added that “How the changes are made could be important.” This need for a § 904(a)/GILTI coordination is one of those very important areas where a regulation is needed.

³ Conf. Report at p. 498.

F. GILTI Foreign Tax Credit Issues.

1. Marjorie Rollinson was quoted as saying the IRS intends to release a regulation package this year on the foreign tax credit implications of the GILTI provisions introduced by the Tax Reform Act. Rollinson was speaking at an International Tax Institute seminar in New York.
2. Ryan Finley reported on Rollinson's presentation: "IRS Trying to Limit TCJA's Damage to Foreign Tax Credits," 2018 WTD 57-2. The article quotes Rollinson as saying that a lot of "damage [was] done to the foreign tax credit system in this act. I don't think they intended damage, but [there's] a lot to be done, and we're going to be focusing on really how to make everything work with the system that we have."
3. Rollinson said that the legislative history makes it clear that Congress intended the amount of the gross-up under § 78 for deemed paid FTCs to fall within the GILTI basket. She also said the structure of the legislation suggests Congress did not intend to substitute the FTC limitation rules with a simple 13.125 percent minimum tax rate for GILTI.
4. "Congress put the GILTI credit mechanism in [section] 904(d), which has a lot of rules. If they had wanted to make it a pure minimum tax, I would have thought they'd have put in § 250," Rollinson said. "But that's not what they did, so I think piecing it all together ... it does appear that that is what Congress intended, that the gross-up be in the GILTI basket."
5. The article reported that Rollinson said comments from taxpayers have focused on how to retain FTC carryovers by allocating them between the general basket and foreign branch basket. However, Rollinson added that it's not clear what transition relief would be appropriate regarding the GILTI basket. "When we ask [taxpayers] how we're going to make sure some of [their FTC carryover] goes to the GILTI basket, most people look shocked and disgusted," Rollinson said. "I think there's a real question about, in terms of transition rules, what the right thing to do is."

G. GILTI and Foreign Tax Credits.

1. NAM also urged Treasury to issue regulations to prevent the additional U.S. tax that may arise when the GILTI provisions are applied in addition to existing expense allocation rules. TNI 9-13-18.
2. NAM states that the GILTI rules, if applied in conjunction with the expense allocation rules, can result in additional US tax liability in excess of the 13.125% GILTI rate. NAM states that other companies and associations have also called on Treasury to provide relief in this area, as its impact could be substantial for companies that have potentially large expenses like interest, research and development and stewardship costs. The U.S. Chambers' comments and Illinois Toolworks' comments were

discussed above. This obviously is an important issue and is not addressed in the proposed regulations discussed below.

3. NAM had an interesting suggestion. Other companies and groups have requested that Treasury modify the expense allocation rules under § 864. NAM says that would be acceptable from its perspective, but it also suggests that Treasury and the IRS give taxpayers the ability to avoid GILTI altogether by providing an election to treat all GILTI income as Subpart F income. That approach would be consistent with Congress' intent to tax GILTI income at a minimum rate, while also preventing the rules from creating unlimited tax liability on GILTI income.
4. NAM states that such an approach would allow taxpayers to use the Subpart F "high tax exception" provision which exempts foreign income from additional U.S. taxation to the extent that the rate of foreign tax on the income exceeds 90% of the U.S. corporate rate. NAM believes that Treasury has ample authority to classify this new category of income as Subpart F income and states that the election would allow taxpayers the certainty that no additional liability from the GILTI provisions would attach to income subject to a foreign tax rate of more than 18.9%.

H. § 904(b)(5).

1. Section 904(b)(4) addresses § 245A. It's entitled "Treatment of Dividends for Which Deduction is Allowed Under § 245A."
2. It has a sentence that reads, "For purposes of [§ 904(a)] [a U.S. shareholder's] ... taxable income from sources without the United States ... shall be determined without regard to (A) the foreign-source portion of any dividend received from such foreign corporation and (B) any deductions properly allocable or apportioned to (i) income (other than amounts includible under § 951(a)(1) or § 951A(a)) with respect to stock of such specified 10% owned foreign corporation, or (ii) such stock to the extent that income with respect to such stock is other than amounts includible under §§ 951(a)(1) or 951A(a)."
3. It's not entirely clear what this means regarding GILTI.

I. GILTI Regulations.

1. Treasury and the IRS proposed regulations under the GILTI rules. The regulations address a number of important provisions, but do not address some other important provisions specifically those regarding foreign tax credit determinations and the allocation and apportionment of expenses under § 904 and issues under § 250.
2. Section 951A requires a U.S. shareholder ("US shareholder") of a controlled foreign corporation ("CFC") for any taxable year to include in

gross income the shareholder's global intangible low-taxed income ("GILTI") for that taxable year. The proposed regulations provide guidance for U.S. shareholders to determine the amount of GILTI to include in gross income ("GILTI inclusion amount").

3. The Tax Cut and Jobs Act ("TCJA") also added two new foreign tax credit provisions relating to GILTI -- § 960(d) provides a foreign tax credit for taxes properly attributable to tested income taken into account by a domestic corporation under § 951A and § 904(d)(1)(A) provides that any amount included in gross income under § 951A (other than passive income) is treated as a separate category of income for purposes of § 904. In addition, new § 250 provides domestic corporations a deduction equal to a percentage of their GILTI inclusion amount and foreign-derived intangible income, subject to a taxable income limitation.
4. As noted above, the proposed regulations do not include any rules relating to foreign tax credits or the deduction under § 250. The preamble states that rules relating to foreign tax credits and the deduction under § 250 will be included in separate notices of proposed rulemaking. It is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the § 78 gross-up attributable to foreign taxes deemed paid under § 960(d) to the separate category described in § 904(d)(1)(A).
5. GILTI.
 - (a) Section 951A(a) provides that a U.S. shareholder of a CFC for a taxable year must include in gross income its GILTI for that year. A GILTI inclusion is treated in a manner similar to the § 951(a)(1)(A) inclusion of a CFC's Subpart F income for many purposes of the Code. § 951A(f)(1). However, a GILTI inclusion is determined in a manner that is fundamentally different from that of an inclusion under § 951(a)(1)(A). Subpart F is determined at the level of a CFC, and then a U.S. shareholder that owns stock directly or indirectly in the CFC generally includes in gross income its pro rata share of the CFC's Subpart F income.
 - (b) Similar to an inclusion under § 951(a)(1)(A), the determination of a U.S. shareholder's GILTI inclusion amount begins with the calculation of certain items of each CFC owned by the shareholder, such as tested income, tested loss or Qualified Business Asset Investment ("QBAI"). A U.S. shareholder then determines its pro rata share of each of these CFC-level items in a manner similar to a shareholder's pro rata share of Subpart F income under § 951(a)(2). However, in contrast to an inclusion under § 951(a)(1)(A), the U.S. shareholder's pro rata shares of these items are not amounts included in gross income, but rather

amounts taken into account by the shareholder in determining the GILTI included in the shareholder's gross income.

- (c) The U.S. shareholder aggregates (and then nets or multiplies) its pro rata shares of each of these items into a single shareholder-level amount – for example, aggregate tested income reduced by aggregate tested loss becomes net CFC tested income and aggregate QBAI multiplied by 10 percent becomes deemed tangible income return.
- (d) A shareholder's GILTI inclusion amount for a taxable year is then calculated by subtracting one aggregate shareholder-level amount from another – the shareholder's net deemed intangible income return ("net DTIR") is the excess of deemed tangible income over certain interest expense, and, finally, its GILTI inclusion amount is the excess of its net CFC tested income over its net DTIR.
- (e) Thus, a U.S. shareholder does not compute a separate GILTI inclusion amount with respect to each CFC for a taxable year, but rather computes a single GILTI inclusion amount by reference to all its CFCs. Because a U.S. shareholder's GILTI inclusion amount is determined based on the relevant items of all the CFCs of which it is a U.S. shareholder, the effect of the provision is generally to ensure that a U.S. shareholder is taxed on its GILTI wherever (and through whichever CFC) derived.
- (f) The proposed regulations follow an outline similar to the description in this overview. Prop. Treas. Reg. §§ 1.951A-2 through 1.951A-4 provide detailed guidance on items determined at the CFC-level – that is, tested income and tested loss, QBAI, and the items necessary to determine the amount of certain interest expense that reduces net DTIR. Prop. Treas. Reg. § 1.951A-1(d) provides rules for determining the U.S. shareholder's pro rata share of the CFC-level items. Finally, Prop. Treas. Reg. § 1.951A-1(c) provides rules describing the aggregation of the U.S. shareholder's pro rata share amounts to determine the shareholder's GILTI inclusion amounts.

6. General Rules and Definitions.

- (a) Prop. Treas. Reg. § 1.951A-1 provides general rules to determine a U.S.'s GILTI inclusion amount and associated definitions. Some of the definitions distinguish between a CFC's taxable year and the U.S. shareholder's taxable year. For example, "U.S. shareholder inclusion year" refers to the relevant taxable year of the U.S. shareholder and is defined as a taxable year of the U.S. shareholder

that includes a CFC inclusion date of the CFC. *See* Prop. Treas. Reg. § 951A-1(e)(4).

- (b) Prop. Treas. Reg. § 1.951A-1(c)(3) defines net DTIR, which is computed at the U.S. shareholder-level based on QBAI held by the shareholder's CFCs and offsets the shareholder's net CFC tested income for purposes of determining the shareholder's GILTI inclusion amount. A CFC's QBAI is equal to its aggregate average adjusted bases in specified tangible property which is defined as tangible property used in the production of tested income. *See* § 95A(d)(2)(A) and Prop. Treas. Reg. § 1.951A-3(c)(1).
- (c) The preamble states that the proposed regulations "clarify" that a tested loss CFC does not have any specified tangible property. The preamble cites H.R. Rep. No. 115-466, at 642, fn. 1536 (2017) ("Conf. Rep."). While we note that this is so stated, it would seem not to be supported by the statute.⁴ Thus, under the proposed regulations, for purposes of calculating its GILTI inclusion amount, a U.S. shareholder does not take into account any tangible property of a tested loss CFC in calculating its aggregate pro rata share of QBAI, its deemed intangible income return, or its net DTIR.
- (d) Section 951A(e)(1) provides that, for purposes of determining a U.S. shareholder's GILTI inclusion amount, the shareholder's pro rata share of a CFC's tested income, tested loss, and QBAI is determined under the rules of § 951(a)(2) in the same manner as that section applies to Subpart F income. Accordingly, the proposed regulations incorporate the pro rata share rules of § 951(a)(2) and Treas. Reg. §§ 1.951-1(b) and (e), with appropriate modifications to account for the differences between Subpart F income, on the one hand, and tested income, tested loss, and QBAI, on the other.
- (e) Similar to the determinations of a U.S. shareholder's pro rata share of Subpart F income, Prop. Treas. Reg. § 1.951A-1(d)(1) provides that a U.S. shareholder's pro rata share of any CFC item necessary for calculating its GILTI inclusion amount is determined by reference to the stock the shareholder owns (within the meaning of § 958(a)) in the CFC ("§ 958(a) stock") as of the close of the CFC's taxable year, including § 958(a) stock treated as owned by the U.S. shareholder through a domestic partnership under Prop. Treas. Reg. § 1.951A-5(c).

⁴ Hopefully, Treasury and the IRS similarly will follow the Conference Report in determining that expenses do not get allocated to the § 904(d) GILTI basket. At least, there is statutory support for that in § 864(d)(7).

- (f) In several places, the provisions of Prop. Treas. Reg. § 1.951A-1(d) reference § 951(a)(2) and Prop. Treas. Reg. § 1.951-1(e), which amends existing Treas. Reg. § 1.951-1(e). Comments requested guidance on how to determine a preferred shareholder's pro rata share of CFC items for purposes of GILTI. Rules relating to the allocation of tested income to preferred stock are included in Prop. Treas. Reg. § 1.951A-1(d)(2) by cross-reference to Prop. Treas. Reg. § 1.951-1(e).
- (g) A U.S. shareholder's pro rata share of tested income generally is determined in the same manner as its pro rata share of Subpart F income under § 951(a)(2) and Treas. Regs. §§ 1.951-1(b) and (e) (that is, based on a relative amount that would be received by the shareholder in a year-end hypothetical distribution of all the CFC's current year earnings). For purposes of determining a U.S. shareholder's pro rata share of a CFC's QBAI, the amount of QBAI distributed in a hypothetical distribution is generally proportionate to the amount of the CFC's tested income distributed in the hypothetical distribution. *See* Prop. Treas. Reg. § 1.951A-1(d)(3)(i). However, a special rule in the proposed regulations provide that if a CFC's QBAI exceeds 10 times its tested income, so that the amount of QBAI allocated to preferred stock would exceed 10 times the tested income allocated to the preferred shareholder under the general proportion and allocation rule, the excess amount of QBAI is allocated solely to the CFC's common stock.
- (h) For purposes of determining a U.S. shareholder's pro rata share of a CFC's tested loss, the amount distributed in the hypothetical distribution is the amount of the tested loss, rather than a CFC's current earnings and profits, and the tested loss is distributed solely with respect to the CFC's common stock, except in certain cases involving dividend arrearages with respect to preferred stock and common stock with no liquidation value. *See* Prop. Treas. Reg. §§ 1.951A-1(d)(4).
- (i) The proposed regulations provide that § 951(a)(2)(B) is applied to reduce tested losses, but modified to treat the amount of a dividend received by another person as equal to the amount of the tested loss, without regard to whether an actual dividend is made by the tested loss CFC. *See* Prop. Treas. Reg. § 1.951A-1(d)(4)(i)(D). The effect of this rule is to reduce the shareholder's pro rata share of tested loss in proportion to the number of days a shareholder did not own the stock of the tested loss CFC within the meaning of § 958(a). Each of these modifications is intended to ensure that the tested loss of the CFC is allocated to each U.S. shareholder in an

amount commensurate with the economic loss borne by the shareholder by reason of the tested loss.

- (j) Prop. Treas. Reg. §§ 1.951A-1(d)(5) and (6) provide rules for determining a shareholder's pro rata share of tested interest expense and tested interest income. Tested interest expense and tested interest income are defined in Prop. Treas. Reg. § 1.951A-4, which is discussed below. A U.S. shareholder's pro rata share of a CFC's tested interest expense for a taxable year equals the amount by which the CFC's tested interest expense reduces the shareholder's pro rata share of tested income, increases the shareholder's pro rata share of tested loss, or both. Conversely, a U.S. shareholder's pro rata share of tested interest income for a taxable year equals the amount by which the CFC's tested interest income increases the shareholder's pro rata share of tested income, reduces the shareholder's pro rata share of tested loss or both.
- (k) Regarding foreign currency translation, because GILTI is computed at the U.S. shareholder level, the tested income, tested loss, tested interest expense, tested interest income, and QBAI of a CFC that uses a functional currency other than a U.S. dollar must be translated into U.S. dollars. The appropriate exchange rate under § 989(b)(3) for income inclusions under § 951(a)(1)(A) is the average exchange rate for the taxable year of the foreign corporation. GILTI inclusion amounts are similar to § 951(a)(1)(A) inclusions, in that both inclusions are determined based on certain income (and, in the case of GILTI, certain losses) of the CFC for the taxable year of the CFC that ends with or within the taxable year of the U.S. shareholder. Therefore, the proposed regulations prescribe the same translation rule for Subpart F income for translating a pro rata share of tested income, tested loss, tested interest expense, tested interest income and QBAI. *See* Prop. Treas. Reg. § 1.951A-1(d)(1). Similarly, a U.S. shareholder's GILTI inclusion amount that is allocated to a tested income CFC under § 951A(f)(2) is translated from U.S. dollars into the CFC's functional currency using the average exchange rate for the taxable year of the tested income CFC.

7. Tested Income and Tested Loss.

- (a) Under Treas. Reg. § 1.952-2(a)(1) and Prop. Treas. Reg. § 1.951A-2(c)(2), tested income or tested loss of a CFC is determined by treating a CFC as a domestic corporation under § 11 and by applying the principles of § 61 and the regulations thereunder. Therefore, only items of deduction that would be allowable in determining taxable income of a domestic corporation may be

taken into account for purposes of determining a CFC's tested income or loss.

- (b) Treasury and the IRS request comments on the application of the rules of Treas. Reg. § 1.952-2 for purposes of determining Subpart F income, tested income, and tested loss. In particular, comments are requested as to whether these rules should allow a CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code. For example, questions have arisen as to whether a CFC should be entitled to a dividends received deduction under § 245A, even though § 245A by its terms applies only to dividends received by domestic corporations.
- (c) Comments also were requested concerning the interaction of §§ 163(j) and § 267A with § 951A. Issues related to §§ 163(j), 245A and 267A will be addressed in future guidance.
- (d) Section 951A(c)(2) requires that gross income of a CFC for the taxable year be determined without regard to certain items. One of these items is gross income excluded from foreign base company income of the CFC by reason of electing the high-tax exception. In response to comments, the proposed regulations clarify that this exclusion applies only to income that is excluded from foreign-base company income solely by reason of an election made to exclude the income under the high-tax exception of § 954(b)(4).
- (e) Accordingly, the exclusion does not apply to income that would not be Subpart F income or to categories of income that do not constitute Subpart F income due to exceptions other than the high-tax exception, for example, as a result of the exception to foreign personal holding company income under § 954(c)(6) or § 954(h).
- (f) Another item excluded from gross tested income is gross income taken into account in determining a corporation's Subpart F income. Comments requested guidance on the interaction between the earnings and profits limitation to Subpart F income under § 952(c), including the recapture rule in § 952(c)(2), and the determination of gross tested income for purposes of § 951A. Treasury and the IRS believe that any income described in § 952(a) is "taken into account in determining Subpart F income" regardless of whether the § 952(c) limitation applies, and therefore should not be included in gross tested income. Conversely, the recapture of Subpart F income under § 952(c)(2), even if by reason of earnings and profits attributable to gross-tested income, does not result in excluding any amount from gross tested income.

Therefore, the proposed regulations provide that tested income and tested loss are determined without regard to the application of § 952(c). *See* Prop. Treas. Reg. § 1.951A-2(c)(4).

- (g) Section 951A(c)(2)(A)(ii) provides that tested income and tested loss are determined by subtracting from the CFC's gross-tested income called "the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of § 954(b)(5) (or to which such deductions would be allocable if there were such gross income)."
- (h) Regulations under § 954(b)(5) require taxpayers to determine that Subpart F income by properly allocating and apportioning deductions to the various categories of Subpart F income. For this purpose, Treas. Reg. § 1.954-1(c) provides that taxpayers must first determine the gross amount of each item of income in a category of income and then allocate and apportion expenses to these categories under the principles of §§ 861, 864 and 904(d).
- (i) Accordingly, in order to apply the principles of § 954(b)(5) to § 951A, the proposed regulations provide that allowable deductions determined under the principles of Treas. § 1.952-2 are allocated and apportioned to gross-tested income under the principles of § 954(b)(5), treating gross-tested income that falls within a single category as an additional category of income for this purpose. *See* Prop. Treas. Reg. § 1.951A-2(c)(3).
- (j) One of the new rules (described below) disregards basis specified in tangible property created in certain taxable transfers occurring before the effective date of § 951A for purposes of calculating QBAI. These rules were cross-referenced in Prop. Treas. Reg. §§ 1.951A-2(c)(5) to disallow any loss or deduction related to such stepped-up basis in any depreciable or amortizable property (including, for example, intangible property) for purposes of calculating tested income or tested loss.

8. QBAI.

- (a) Treas. Reg. § 1.951A-3(b) provides that a tested income CFC's QBAI for any taxable year is the average of the CFC's aggregate adjusted basis as of the close of each quarter in the specified tangible property that is used in a trade or business of the corporation and of a type with respect to which a deduction is allowable under § 167.
- (b) In general, specified tangible property is tangible property used in the production of tested income. *See* Prop. Treas. Reg. 1.951A-

3(c)(1). Tangible property is defined as property for which the depreciation deduction provided by § 167 is eligible to be determined under § 168 (even if the CFC has elected not to apply § 168). The proposed regulations define tangible property by reference to whether the property can be depreciated under § 168 because, unlike § 167, § 168 applies only to tangible property and there is a substantial amount of guidance delineating property subject to § 168.

- (c) Property that is used in the production of both gross-tested income and gross income that is not gross-tested income (“dual use property”) is proportionately treated as specified tangible property. *See* Prop. Treas. Reg. § 1.951A-3(d)(1).
- (d) Prop. Treas. Reg. § 1.951A-3(e) provides rules to determine the adjusted basis of specified tangible property for purposes of determining QBAI. The general rule in the proposed regulation provides that the adjusted basis in any property is determined by using the alternative depreciation system under § 168(g) (“ADS”). Treasury and the IRS recognize that taxpayers may hold specified tangible property that was acquired before December 22, 2017, and that was not depreciated using the ADS under § 168(g). Section 951A(d) does not distinguish between property acquired before December 22, 2017 and property acquired on or after that date. Treasury and the IRS have concluded that, regardless of the date acquired, the adjusted basis in specified tangible property should be determined under ADS in order for the U.S. shareholder’s pro rata share of QBAI to be properly determined and not distorted. Therefore, the proposed regulations provide that when determining QBAI, the adjusted basis in property placed in service before December 22, 2017 must be determined using the ADS as if this system had applied from the date that the property was placed in service.
- (e) Section 951A(d)(3) (“the partnership QBAI paragraph”) states that if a CFC holds an interest in a partnership at the close of the CFC’s taxable year, the CFC takes into account under § 951A(d)(1) its “distributive share of the aggregate of the partnership’s adjusted bases” in the specified tangible property in computing its QBAI. The partnership QBAI paragraph further provides that a CFC’s distributive share of the adjusted basis of any property is the CFC’s distributive share of income with respect to such property.
- (f) The statutory language is ambiguous because the term “distributive share” is used with respect to income, gain, and so forth, but not the basis of assets. The proposed regulations therefore use the term “share” (rather than “distributive share”) when referring to

the amount of the inside basis of a partnership asset that a partner that is a CFC may include in its QBAI.

- (g) Because there is some ambiguity with respect to providing that a CFC “shall take into account” the CFC’s distributive share of basis in partnership property, the proposed regulations provide that a CFC partner’s share of the partnership’s adjusted basis in specified tangible property is by reference to the partnership’s average adjusted basis in the property as of the close of each quarter of the partnership’s taxable year that ends with or within the CFC’s taxable year. *See* Prop. Treas. Reg. § 1.951A-3(g)(3).

9. Anti-Abuse Provisions.

- (a) Section 951A(d)(4) provides that “the Secretary shall issue such regulations or other guidance as the Secretary determines appropriate to prevent the avoidance of the purposes of this subsection, including regulations or other guidance which provide for the treatment of property if—(A) such property is transferred, or held, temporarily, or (B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.” The Conference Report describes the scope of this anti-avoidance rule by stating that “the conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders ... to minimize tax under this provision be disregarded.” Conf. Rept. at p. 645.
- (b) Consistent with § 951A(d)(4) and the Conference Report, as well as Treasury’s broad authority under § 7805(a) to “prescribe all needful rules and regulations for the enforcement of” the Code, the proposed regulations provide that specified tangible property of a tested income CFC is disregarded for purposes of determining the tested income of the CFC’s average aggregate basis and specified tangible property if the tested income CFC acquires a property with a principal purpose of reducing the GILTI inclusion amount of a US shareholder and holds the property temporarily but over at least one quarter end. *See* Prop. Treas. Reg. § 1.951A-3(h)(1).
- (c) In addition, property held for less than a twelve-month period that includes at least one quarter end during the table year of a tested income CFC is treated as temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount of a US shareholder.
- (d) This anti-abuse rule undoubtedly will draw a lot of negative commentary by tax advisors and tax executives, in particular, the “per se” rule regarding property held for less than a twelve-month

period. That property is deemed to be held for the tainted principal purpose. The rule seems overbroad.

- (e) The preamble states that Treasury and the IRS are aware that taxpayers are engaging in transactions like the ones described in the Conference Report involving taxable transfers of property from one CFC to another CFC before the first taxable year of the transferor CFC to which § 951A applies in order to provide the transferee CFC with a stepped-up basis in the transferred property that, for example, may increase a U.S. shareholder's amount of QBAI with respect to the CFC for periods when it is subject to § 951A.
- (f) The preamble states that the stepped-up basis may also reduce the transferee CFC's tested income or increase its tested loss during period when it is subject to § 951A. Treasury and the IRS have determined that it would be inappropriate for a taxpayer to reduce its GILTI inclusion amount for any taxable year by reason of stepped-up basis in CFC assets attributable to transactions between related CFCs during a period after December 31, 2017 but before the effective date of § 951A.
- (g) Accordingly, the proposed regulations disallow the benefit of a stepped-up basis in specified intangible property transferred between related CFC's during the period before the transfer or CFC's first inclusion year for purposes of calculating a transferee CFC's QBAI. *See Prop. Treas. Reg. § 951A-3(h)(2).*
- (h) The preamble also states that U.S. tax results claimed with respect to transactions that fall outside the scope of the anti-abuse rule in the proposed regulations may, nonetheless, be challenged under other statutory provisions or judicial doctrines. This provision, too, can be expected to draw a lot of negative commentary. It suggests that even transactions not covered by the general anti-abuse rule or the "per se" anti-abuse rule may nonetheless be challenged if a tax examiner decides that such a transaction should be challenged for unspecified reasons.

10. Specified Interest Expense.

- (a) To calculate a U.S. shareholder's net DTIR, § 951A(b)(2)(B) provides that 10% of the aggregate of the shareholder's pro rata share of the QBAI of each CFC is reduced by "the amount of interest expense taken into account under subsection (c)(2)(A)(ii) in determining such shareholder's net CFC tested income for the taxable year to the extent the interest income attributable to such

expense is not taken into account in determining such shareholder's net CFC tested income.”

- (b) Deductions taken into account under § 951A(c)(2)(A)(ii) are deductions (including taxes) that are properly allocable to gross tested income for purposes of calculating tested income and tested loss. Thus, only a U.S. shareholder's pro rata share of interest expense that is currently deductible and properly allocable to gross tested income is taken into account for purposes of determining the interest expense described in § 951A(b)(2)(B).
- (c) Specified interest expense is a U.S. shareholder-level determination which is net of “attributable” interest income taken into account by the U.S. shareholder. Specifically, specified interest expense of a U.S. shareholder is its pro rata share of interest expense properly allocable to gross tested income reduced by its pro rata share of interest income included in gross tested income to the extent attributable to that interest expense. The effect of this formulation is to count against net DTIR only a U.S. shareholder's pro rata share of interest expense allocable to gross tested income to the extent that the related interest income is not also reflected in the U.S. shareholder's pro rata share of the tested income of another CFC, such as in the case of a third-party interest expense or interest expense paid to related U.S. persons.
- (d) The amount of interest income “attributable” to interest expense is not defined in § 951A(b)(2)(B). Treasury and the IRS determined that a tracing approach with specified interest expense would be administratively burdensome and difficult to reconcile with the framework of § 951A. A tracing approach for specified interest would necessitate a hybrid determination, and would create particular complexity with respect to interest paid between CFCs that are owned by different U.S. shareholders in different proportions.
- (e) Treasury and the IRS have instead determined that a netting approach to specified interest expense accomplishes the purpose of the specified interest expense rule in a more administrable manner and is consistent with the requirement that “attributable” interest income be netted against interest expense. Therefore, the regulations provide that a U.S. shareholder's specified interest expense is the excess of its aggregate pro rata share of the tested interest expense of each CFC over its aggregate pro rata share of the tested interest income of each CFC. *See* Prop. Treas. Reg. § 1.951A-1(c)(3)(iii).

- (f) Comments have questioned whether interest expense of a captive finance CFC must be taken into account for purposes of determining a U.S. shareholder's specified interest expense, or whether the related interest income from unrelated customers may be available to offset such interest expense. Treasury and the IRS have determined that a U.S. shareholder's specified interest expense, and therefore its net DTIR and its GILTI inclusion amount, should not depend on whether the U.S. shareholder has one or more CFCs engaged in the act of conduct of a financing or insurance business, as long as the interest expense of the CFC is incurred exclusively to fund such business with unrelated persons and thus is not incurred, for example, to fund the acquisition of specified tangible property.
- (g) Therefore, the proposed regulations exclude from the definition of tested interest expense any interest expense of a CFC that is an eligible CFC or a qualifying insurance company, except to the extent of the qualified CFC's assets unrelated to its financing or insurance business and any interest income received by the qualified CFC from loans to certain related persons. *See Prop. Treas. Reg. § 1.951A-4(b)(1)(iii).*
- (h) For purposes of determining specified interest expense, interest income and interest expense are broadly defined to encompass any amount treated as interest under the Code or regulations, and any other amount incurred or recognized in a transaction or series of integrated or related transactions in which the use or forbearance of funds is secured for a period of time if the expense or loss is predominantly incurred in consideration of the time value of money. *See Prop. Treas. Reg. §§ 1.951A-4(b)(1)(ii) and (2)(ii).*
 - i Comments requested clarification regarding whether the interest expense of a tested loss CFC is used in a determination of specified interest expense. Regardless of whether interest expense increases tested loss or reduces tested income, the expense is "taken into account ... in determining the shareholder's net CFC tested income" within the meaning of § 951A(b)(2)(B).

11. Domestic Partnerships and Partners.

- (a) Comments requested guidance on the treatment of domestic partnerships that own stock in CFCs. Section 951A does not itself contain any specific rules on domestic partnerships and their partners that directly or indirectly own stock of CFCs. Accordingly, Prop. Treas. Reg. § 1.951A-5 provides this guidance to domestic partnerships and their partners on how to compute

their GILTI inclusion amounts. This guidance also applies to S corporations and their shareholders, which are treated as partnerships and partners for purposes of §§ 951 through 965. *See* § 1373.

- (b) A domestic partnership is a U.S. person by definition and can therefore be a U.S. shareholder of a CFC. Under current law, a domestic partnership that is a U.S. shareholder includes in gross income its § 951(a)(1)(A) inclusion with respect to a CFC, and its partners include in gross income the distributor's share of that inclusion. However, there is no analog in § 951(a)(1)(A) to the U.S. shareholder-level determinations required by § 951A, and thus the level at which the § 959(a)(1)(A) determination is made—whether at the level of the partnership or its partners—does not generally affect the amount of the inclusion if the partnership and its partners are all U.S. shareholders.
- (c) On the other hand, the GILTI inclusion amount is an aggregation of the U.S. shareholder's pro rata shares of tested income, tested loss, QBAI, tested interest expense, and tested interest income of each of its CFCs. Thus, the level at which the GILTI calculation is made dictates the CFC items to be taken into account by the shareholder, and each of these items can impact the shareholder's GILTI inclusion amount.
- (d) Treasury and the IRS considered a number of approaches regarding applying § 951A with respect to domestic partnerships and their partners. A pure aggregate approach and a pure entity approach each raised issues. They ultimately determined that the approach that best harmonizes the treatment of domestic partnerships and their partners across all provisions of the GILTI regime is neither a pure aggregate nor a pure entity approach. Rather, the most harmonious approach treats a domestic partnership as an entity with respect to partners that are not U.S. shareholders of any CFC owned by the partnership, but treats the partnership as an aggregate for purposes of partners that are themselves U.S. shareholders with respect to one or more CFCs owned by the partnership.
- (e) This novel approach regarding domestic partnerships, while a unique approach, would seem to solve complex mechanical problems that otherwise would arise under the GILTI regime. While it may create some complexity, we suspect that it will be applauded by most practitioners.

12. Treatment of GILTI Inclusion Amount.

- (a) A U.S. shareholder's GILTI inclusion amount is not an inclusion under § 951(a)(1)(A). Nevertheless for purposes of some provisions, GILTI inclusion amounts are treated similarly to § 951(a)(1)(A) inclusions. § 951A(f)(1)(A). Section 951A(f)(1)(B) grants Treasury authority to provide rules applying § 951A(f)(1)(A) to other provisions of the Code. Thus, the proposed regulations provide that a GILTI inclusion is treated in the same manner as a Subpart F inclusion for purposes of applying § 1411, the net investment income rules.
- (b) Comments have requested that regulations clarify that an inclusion under § 951A is determined before an inclusion under § 951(a)(1)(B) (§ 956). Treasury and the IRS have determined that clarification is unnecessary because a GILTI inclusion amount is treated as § 951(a)(1)(A) inclusion. For purposes of § 959, the determination of the amount included under § 951(a)(1)(B) is made after the determination of the amount of a § 951(a)(1)(A) inclusion and the GILTI inclusion amount. Treasury and the IRS intend to issue a separate notice of proposed rulemaking to update the regulations under §§ 959 and 961 to account for the TCJA's modifications to the U.S. international tax system, including the enactment of § 245A.
- (c) Section 267(a)(3)(B) generally provides that a deduction for an item payable to a related CFC is not allowed until paid, except to the extent that an amount attributable to that item is included in gross income of a U.S. shareholder. Treasury and the IRS have determined that deductions should not be deferred under §§ 163(e)(3)(B)(i) and 267(a)(3)(B) to the extent that an item is taken into account in determining a U.S. shareholder's GILTI inclusion amount. *See* Prop. Treas. Reg. § 1.951A-6(c)(1).
- (d) In determining a U.S. shareholder's net CFC tested income, the U.S. shareholder's pro rata share of a tested loss of one CFC may offset the shareholder's pro rata share of tested income of another CFC. Such a use of a tested loss does not reduce the U.S. shareholder's basis in the stock of the tested loss CFC, increase the stock basis of the tested income CFC, or affect the earnings and profits of either the tested loss CFC or the tested income CFC.
- (e) Treasury and the IRS have determined that in certain cases, the lack of adjustments to stock basis of a tested loss CFC can lead to inappropriate results. For example, if the U.S. shareholder's basis in the stock of the tested loss CFC is not reduced to reflect the use of the tested loss to offset tested income taken into account by the

U.S. shareholder, the U.S. shareholder would recognize a second and duplicative benefit of the loss —either through the recognition of a loss or the reduction of gain— if the stock of the tested CFC is disposed of. On the other hand, in the case of a corporate U.S. shareholder, but not in the case of an individual, gain recognized on the disposition of the CFC attributable to offset tested income would, in most cases, be eliminated as a result of the application of § 964(e) or § 1248(a) and (j), to the extent the gain is recharacterized as a dividend that is eligible for the dividends received deduction under § 245A.

- (f) Accordingly, Prop. Treas. Reg. § 1.951A-6(e) generally provides that in the case of a corporate U.S. shareholder (excluding regulated investment companies and real estate investment trusts), for purposes of determining the gain, loss or income on the direct or indirect disposition of stock of the CFC, the basis of the stock is reduced by the amount of tested loss that has been used to offset tested income in calculating net CFC tested income of the U.S. shareholder. The basis reduction is made only at the time of the disposition and therefore does not affect the stock basis prior to a disposition.
- (g) The basis adjustments apply only to the extent a “net” tested loss of the CFC has been used. Similar adjustments apply when the tested loss CFC is treated as owned by the U.S. shareholder through certain intervening foreign entities by reason of § 958(a)(2) to prevent the indirect use of the duplicative loss through the disposition of interests in those intervening entities. *See* Prop. Treas. Reg. § 1.951A-6(e)(1)(ii).

13. Pro rata Share Rules.

- (a) Treas. Reg. § 1.951-1(e) was revised in 2005 and 2006 to address certain avoidance structures, such as structures that resulted in non-economic allocations of Subpart F income to shareholders of CFCs that were not U.S. shareholders. Treasury and the IRS have become aware of additional avoidance structures. For example, the existing regulations require an allocation of earnings and profits between classes of stock with discretionary distribution rights based on the fair market value of the stock. While this rule appropriately allocates Subpart F income in some cases, some taxpayers have attempted to improperly allocate Subpart F income by applying these rules to certain structures involving shares with preferred liquidation and distribution rights.
- (b) The notice of proposed rulemaking proposes to amend Treas. Reg. § 1.951-1(e) to address these avoidance structures, which implicate

§ 951A as well as § 951. The proposed regulations clarify that, for purposes of determining a U.S. shareholder's pro rata share Subpart F income, earnings and profits for the taxable year are first hypothetically distributed among the shares of stock and then hypothetically distributed to each share in the class on the hypothetical distribution date, which is the last day of the CFC's taxable year on which it is a CFC.

- (c) In lieu of prescribing a determination based on fair market value, the proposed regulations provide that the amount of earnings and profits that would be distributed with respect to the classes of stock is based on all relevant facts and circumstances. *See* Prop. Treas. Reg. § 1.951-1(e)(3)(d).
- (d) In addition, under an anti-avoidance rule, the proposed regulations also disregard any transaction or arrangement that is part of a plan a principal purpose of which is to reduce a U.S. shareholder's pro rata share of the Subpart F income of a CFC. *See* Prop. Treas. Reg. § 1.951-1(e)(6). This rule applies for purposes of determining a U.S. shareholder's pro rata share of amounts for purposes of calculating a shareholder's GILTI inclusion amount, as well.
- (e) The proposed regulations also modify Treas. Reg. § 1.951-1(e) in specific ways to take into account § 951A. For example, the proposed regulations provide that a U.S. shareholder's pro rata share of the CFC's Subpart F income is determined by reference to the shareholder's proportionate share of the total current earnings and profits that would be distributed in the hypothetical distribution.
- (f) In addition to determining a U.S. shareholder's pro rata share of a CFC's Subpart F income, Treas. Reg. § 1.951-1(e) also applies for purposes of determining the shareholder's pro rata share of the CFC's tested income. However, because tested income is not limited to the earnings and profits of a CFC, and because a CFC's tested loss increases its earnings and profits for purposes of determining the Subpart F income limitation in § 952(c)(1), the earnings and profits allocated in the hypothetical distribution may exceed the earnings and profits of the CFC computed under § 964. Accordingly, the hypothetical distribution in the proposed regulations is based on the greater of the § 964 earnings and profits on the sum of the Subpart F income (increased by reason of any tested loss add-back under § 951A(c)(2)(B)(ii) and Prop. Treas. Reg. § 1.951A-6(d)) and tested income of the CFC.

14. Partnership Blocker Structures.

- (a) Notice 2010-41, 2010-22, I.R.B. 715, stated that forthcoming regulations would treat a domestic partnership as a foreign partnership for purposes of identifying the U.S. shareholder of a CFC required to include in gross income its pro rata share of the CFC's Subpart F income in the circumstances described in the notice. Treasury and the IRS have determined that the same rule should also apply to identify the U.S. shareholder of a CFC for purposes of § 951A.
- (b) Accordingly, the proposed regulations treat certain controlled domestic partnerships as foreign partnerships for purposes of identifying a U.S. shareholder for purposes of §§ 951 through 964. *See also* Prop. Treas. Reg. § 1.965-1(e) adopting a similar partnership blocker rule for purposes of the § 965 regulations.

15. Section 1502.

- (a) A consolidated group member's inclusion of Subpart F income under § 951(a)(1)(A) is determined at the member level. However, § 951A requires an aggregate, U.S. shareholder-level calculation, under which a member's pro rata share of the relevant items of one CFC can increase or decrease a member's GILTI inclusion amount otherwise resulting from its ownership of another CFC. Accordingly, a determination of a member's GILTI inclusion amount solely based on a pro rata share of the items of a CFC the stock it which is owned by that member may not result in a clear reflection of the consolidated group's income tax liability.
- (b) Treasury and the IRS have determined that a member's GILTI inclusion amount should be determined by reference to the relevant items of each CFC owned by members of the same consolidated group. Under Prop. Treas. Reg. § 1.1502-51, the proposed regulations provide special definitions of net CFC-tested income and net DTIR in order to clearly reflect the income tax liability of a consolidated group. Specifically, the proposed regulations provide that, to determine a member's GILTI inclusion amount, the pro rata shares of tested loss, QBAI, tested interest expense, and tested interest income of each member are aggregated, and then a portion of each aggregate amount is allocated to each member of the group that is a U.S. shareholder of a tested income CFC based on a proportion of such member's aggregate pro rata share of tested income to the total tested income of the consolidated group.
- (c) Treas. Reg. § 1.1502-32 provides rules for adjusting the basis of stock of a subsidiary owned by another member to reflect, among

other items, the subsidiary's items of income. Accordingly, no new rules are necessary to adjust the basis of stock of a member because of a GILTI inclusion. However, new rules adjust the basis of stock of a CFC immediately before its disposition. Therefore, Prop. Treas. Reg. §§ 1.1502-32(b)(3)(ii)(E) and (iii)(C) treat a portion of a member's offset tested income amount as tax-exempt income and all of a member's used tested loss amount as a noncapital, nondeductible expense.

- (d) Prop. Treas. Reg. § 1.1502-32(b)(3)(ii)(F) provides that a member is also treated as receiving tax-exempt income immediately before another member recognizes income, gain, deduction or loss with respect to a share of the first member's stock.
- (e) Treasury and the IRS request comments regarding the coordination of these rules.

J. NYSBA: GILTI Report.

1. The NYSBA released an excellent 115-page report (before the new GILTI regulations) discussing GILTI issues and recommendations. The report outlines policy considerations and provides examples highlighting various GILTI implementation issues that need to be resolved.
2. The report highlights that GILTI is a hybrid between a flat tax on foreign income and an imperfect add-on to the existing rules for foreign source income. The NYSBA believes that Congress intended a flat tax. We agree. It is clear that Congress intended that there be a direct relationship between the foreign tax rates.
3. The NYSBA points out that although congressional intent is clear that GILTI is a flat tax, by subjecting GILTI to the FTC limitation rules in § 904, the GILTI tax becomes an add-on tax rather than a pure flat tax on low income. The § 904 limitations, if applicable, would create a combined GILTI tax rate well in excess of 13.125% in many situations. The NYSBA also recommends fixing the FTC rules to reflect the congressional intent to impose a flat tax. However, the NYSBA nonetheless recommends that "some" expenses be allocated to GILTI under § 904.
4. The NYSBA recommends the aggregation of members of a consolidated group for GILTI calculation purposes. Although each U.S. corporation must calculate its own GILTI inclusion, the report recommends that GILTI calculations should be aggregated and determined on a consolidated group basis. The NYSBA puts forth five reasons why the GILTI calculations should be determined on a consolidated aggregate basis, including administrative ease and policy considerations. The report

also states that Treasury has the regulatory authority under § 1502 to authorize an aggregate approach to consolidation for GILTI.

5. The report discusses a number of examples illustrating the impact of consolidation on the GILTI calculations. In some situations it produces a better result and in other situations it does not. One policy problem with the GILTI tax is that CFCs with losses are treated less favorably than CFCs with positive income.
6. Without regulations, GILTI consolidation would be an elective regime that taxpayers could structure into, adding unnecessary complexity. Taxpayers could face adverse tax consequences solely because they did not plan their entity structure optimally and held CFCs through multiple members. There is no policy reason why taxpayers should face different results under GILTI based on where CFCs are held within the group.
7. The report discusses the fact that there is no guidance on how CFC deductions are determined in calculating the GILTI tested income. The NYSBA outlines three methods for determining which expenses of a CFC should be allowed as a deduction. Under the “modified taxable income method,” costs that would be allowable as a deduction to a U.S. corporation would be allowed, unless specifically identified as excluded by Treasury. The second method is the “Subpart F method” where all costs of the type deductible for Subpart F purposes would be allowed. The third method is the “modified Subpart F method” where the Subpart F method would apply with certain adjustments.
8. The NYSBA believes that the modified taxable income method is the preferable method since “gross income,” the initial component of tested income, is based on U.S. tax principles. A disadvantage of the modified income method is that it would require a separate hypothetical tax return for each CFC to determine gross income based on U.S. tax principles. However, the other methods would also require some calculation of U.S. tax.
9. The difficulties in calculating the GILTI gross income is inherent in nature of the unique GILTI tax system which imposes a current U.S. tax on the income of CFCs. It is the nature of the GILTI tax itself which is complex and not much can be done to make the calculation less complex.
10. The Subpart F method imports Subpart F principles into the GILTI calculations. The problem is GILTI is not based on or limited to earnings and profits (“E&P”). GILTI involves a greater amount of potential income inclusions and is significantly broader than Subpart F. The rules for Subpart F should not be applied to GILTI without at least some adjustment to reflect the differences between Subpart F and GILTI.

11. The report states that the modified Subpart F method is superior to the Subpart F method and is a realistic alternative to the modified taxable income method. The modified Subpart F method starts with the Subpart F method and then incorporates specific identified disallowed deductions. A significant disadvantage of this method is that it involves dealing with three different tax systems. First, GAAP income must be determined under the Subpart F method. Then, adjustments to GAAP income are required. Finally, the result must be compared to U.S. taxable income with specified adjustments (the modified taxable income method) to see if the differences are material. It is not clear that this process is any simpler than simply using the modified taxable income method in the first place.
12. Regardless of the method for determining tested income, the NYSBA recommends that to the extent a U.S. corporation would be entitled to carry over a loss or deduction to a future year, the same should be true under GILTI with rules similar to the existing rules for NOL carryovers. The report describes two alternative methods to carryover unused tested losses, one at the CFC level and the other at the shareholder level. A carryover of losses at the CFC level, similar to an NOL carryforward of a domestic corporation, gives rise to extremely complex issues because the GILTI income inclusion occurs at the shareholder level. The NYSBA prefers the shareholder level approach to allow the U.S. shareholder to use the loss to reduce its GILTI inclusions in future years.
13. The NYSBA also recommends that if Treasury determines that § 163(j) applies to a CFC, that § 163(j) and GILTI coordination rules be implemented including a rule allowing the carryover of any unused interest deductions.
14. In terms of other computations issues, the NYSBA recommends that regulations should confirm that tested income of a CFC is determined before § 956 inclusions. If § 956 inclusions were determined before tested income, the result would be a double inclusion since tested income is not reduced by § 956 inclusions and is not limited to E&P. The report recommends clarifying rules for when CFC stock is sold and clarifying rules for preferred stock. Regulations should clarify that for purposes of the taxable income limit in § 250(a)(2), taxable income includes all § 951A, Subpart F, § 78, and FDII inclusions, without regard to the § 250(a)(1) deduction. In addition, regulations should clarify whether the § 250(a)(2) carve-back applies to a § 78 gross-up amount for a § 951A inclusion.
15. The report discusses a number of important FTC issues and provides helpful recommendations.
16. In terms of determining the amount of FTCs, the report recommends that once foreign taxes are determined to be attributable to tested income,

regulations should clarify that it is not necessary to trace the taxes as long as the items of tested income are included in the foreign tax base. Regulations should also confirm that a foreign tax is a tested foreign income tax as long as the underlying income giving rise to the foreign tax is included in the tested income of the CFC for any year. A contrary rule would require the tracing of every item of tested income to every item of foreign tax, to make sure they arose in the same taxable year. This would not be administrable and would result in large amounts of foreign taxes being disqualified because of minor timing differences.

17. The NYSBA states that regulations should confirm that any withholding tax on a distribution of tested income that is previously taxed income (“PTI”) should not be subject to the 20% cutback or the inclusion percentage cutback.
18. U.S. shareholder expense allocation is an important GILTI issue that arises from trying to fit GILTI into the regular FTC regime. Under the existing § 904 regulations, the expenses of the U.S. shareholder must be divided between U.S.-source and foreign-source, and then the foreign-source expenses are further divided among the applicable limitation baskets. This allocation creates a GILTI tax in excess of 13.125% for a lot of taxpayers. The NYSBA report states that if Treasury determines that no expenses of the U.S. shareholder are “properly allocable” to income in the GILTI basket, Treasury could issue regulations that no allocation of expenses to that basket should be made.
19. The report outlines some reasons why arguably the allocation of deductions to foreign income may have been intentional. As a policy matter the NYSBA report states that there should not be a complete exclusion of shareholder expenses from the GILTI basket. Although the NYSBA recognizes that some shareholder expenses may be properly allocated to GILTI, the report recommends minimizing expense allocations to GILTI since the result of excess credits in the GILTI basket are a draconian result due to the inability to carry them over. The NYSBA recommends that the existing regulatory framework for allocating expenses should not be applied wholesale to GILTI, and consideration should be given to modifying certain of the existing allocation rules to minimize allocations to GILTI inclusions that are not economically justified.
20. Regulations regarding the application of new § 904(b)(4) should be issued clarifying whether it results in the calculation of FTC baskets by disregarding all exempt income from a CFC and shareholder expenses, without any reallocation of such expense to other income or assets. The NYSBA recommends regulations be issued to confirm that the portion of the § 250 deduction that is allocable to the GILTI inclusion is allocated to the GILTI basket.

21. The NYSBA recommends that the § 78 gross-up for foreign taxes deemed paid under § 960(d) should be in the GILTI basket. The Senate bill explicitly provided that the § 78 gross-up was in the GILTI basket, but this provision was removed in the final bill. However, the NYSBA report states that explicitly providing that the gross-up belongs in the GILTI basket might have been deemed unnecessary because it is not logical for the § 78 gross-up to be in any basket other than the GILTI basket when the underlying income giving rise to the grossed-up taxes is tested income. If this position is rejected, so the gross-up is in the general basket, the NYSBA recommends regulations providing that the portion of the foreign tax allocable to the gross-up is also in the general basket.
22. The NYSBA recommends regulations confirming that interest, rent and royalties received by a U.S. shareholder from its CFC should be treated as non-GILTI inclusions for § 904(d) purposes. Legislation also should be adopted to treat foreign taxes on items that are not in the U.S. tax base as being in a basket determined on the basis of the facts and circumstances, rather than always being in the general basket. If this recommendation is rejected, a statutory amendment (a technical correction) should be adopted to correct a drafting error that now puts these residual taxes in the branch basket.
23. The NYSBA recommends regulations providing that withholding tax on distributions of PTI tested income be in the GILTI basket.
24. In terms of partnership issues, the NYSBA recommends that if a CFC is held through a U.S. partnership, the GILTI inclusion and the § 250 deduction should be determined at the partner level. A partnership approach makes aggregation elective through tax planning and structuring. Coordination rules with § 163(j) would be necessary. If regulations determine instead that the GILTI inclusion and deduction should be made at the partnership level, they should clarify how the rules apply to various ownership situations and what level the GILTI calculations are made.
25. The report also discusses the effect of § 962, the consequences of repeal of the § 958(b)(4) exception to the attribution rules, and the application of the GILTI rules to a RIC, REIT, or tax-exempt shareholder.

IV. FDII.

- A. Section 250(b) provides benefits for foreign-derived intangible income (“FDII”).
 1. Under § 250(b)(4), the term FDII eligible income means income which is derived in connection with property which is sold (“sold” includes licensed) by the taxpayer to any person who is not a United States person and which the taxpayer establishes to the satisfaction of the IRS is for a foreign use.

2. Services income qualifies if the services are rendered to persons not located in the U.S. or with respect to property not located within the U.S.
3. Under § 250(b)(5)(A), foreign use means any use, consumption or disposition which is not within the United States.
4. FDII is based on § 250(b)(3)'s definition of "Deduction Eligible Income." This means qualifying gross income less deductions "properly allocable" to such income. "Properly allocable" is a term used elsewhere, for example, in §§ 862(b) and 954(b)(5). Regulations might need to address the issue for FDII purposes.
5. A branch cannot earn FDII ("income attributable" to a branch cannot be FDII). § 250(b)(3)(A).

B. § 927.

1. There is some prior guidance regarding these terms that might be helpful pending the issuance of FDII regulations. Temp. Treas. Reg. § 1.927(a)-1T(c)(2) (which interestingly is not on the IRS list of 298 regulations proposed for elimination) provides rules for foreign "use, consumption or disposition" under the foreign sales corporation ("FSC") rules. Temp. Treas. Reg. § 1.927(a)-1T(d) states that property is sold or leased for direct use, consumption, or disposition outside the United States if the sale or lease satisfies (i) the destination test set forth in those regulations, (2) the proof of compliance rules, and (3) the "use outside the United States" test.
2. The destination test focuses on establishing shipping terms that show the property indeed was shipped to a foreign destination. Proof of compliance with the destination test is satisfied by producing documentation such as an export bill of lading that shows the property was shipped to a foreign destination.
3. Under Temp. Treas. Reg. § 1.927(a)-1T(d)(4), the "use outside the U.S." test is satisfied if the property is not sold for ultimate use in the U.S. or is leased for ultimate use outside the U.S.
4. Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(ii) states that the purchaser or property is deemed to ultimately use the property in the U.S. if any one of the following conditions exist: (1) the purchaser is a related party with respect to the seller and the purchaser ultimately uses the property, or a second product into which the property is incorporated as a component, in the U.S.; (2) at the time of the sale, there is an agreement or understanding that the property, or a second product into which the property is incorporated as a component, will be ultimately used by the purchaser in the U.S.; (3) at the time of sale, a reasonable person would have believed that the property or the second product would be ultimately used by the

purchaser in the U.S. unless, in the case of a sale of components, the fair market value of the components at the time of delivery to the purchaser constitutes less than 20% of the fair market value of the second product into which the components are incorporated.

C. Note: A FDII Special Rule? A footnote in Tax Act's JCT report suggests that if the property is sold to a foreign person and the property is subject to further manufacture or incorporation as a component, then the property is sold for a foreign use. Conf. Rep. at p. 497 fn. 1522.

D. § 864.

1. The § 864 regulations also address these terms. Treas. Reg. § 1.864-6(b)(3)(ii)(a) contains rules for determining the country of use, consumption or disposition of property. As a general rule, personal property that is sold to an unrelated person is presumed to have been sold for use, consumption or disposition in the country of destination of the property sold. However, if at the time of the sale of the property to an unrelated person, the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed or disposed of in the country of destination, the taxpayer must determine the country of ultimate use, consumption or disposition of the property or the property will be presumed to have been sold for use, consumption or disposition in the U.S.
2. Under Treas. Reg. § 1.864-6(b)(3)(ii)(a), a taxpayer who sells property to a related person is presumed to have sold the property for use, consumption, or disposition in the U.S. unless the taxpayer establishes the use made of the property by the related person. Once the taxpayer has established that the related person has disposed of the property, the rules above relating sales to an unrelated person will apply at the first stage in the chain of distribution at which a sale is made by a related person to an unrelated person.
3. Notwithstanding the preceding § 864 provisions, a taxpayer who sells personal property to any person whose principal business consists of selling from inventory to retail customers at retail outlets outside the U.S. may assume at the time of sale to that person that the property will be used, consumed, or disposed of outside the U.S.
4. For purposes of these rules, a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person or persons own or control directly or indirectly both. The term "control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

5. Treas. Reg. § 1.864-6(b)(3)(ii)(b) provides that a taxpayer who sells personal property to a purchaser which because of its fungible nature cannot reasonably be specifically traced to other purchasers and to the countries of ultimate use, consumption or disposition must, unless the taxpayer establishes a different disposition as being proper, treat that property as being sold for ultimate use, consumption or disposition in those countries, and to those purchasers in the same proportions in which the property from the fungible mass of the first purchaser is sold in the ordinary course of business by the first purchaser. The regulation states that no apportionment is required to be made on the basis of sporadic sales by the first purchaser. This rule will apply only in cases where the taxpayer knew, or should have known from the facts and circumstances surrounding the transaction, the manner in which the first purchaser disposes of property from the fungible mass.

E. Unrelated Domestic Intermediaries.

1. Section 250(b)(5)(B) provides certain rules that relate to property or services provided to domestic intermediaries.
 - (a) If a taxpayer sells property to another person (other than a related person) for further manufacture or other modification within the U.S., the property will not be treated as sold for a foreign use even if such other person subsequently uses the property for a foreign use.
 - (b) The services rule's analog to this sales rule provides that if the taxpayer provides services to unrelated persons located in the U.S., the services do not qualify even if the other person uses the services in providing services which do so qualify.
2. An analogous rule under the Domestic International Sales Corporation ("DISC") and FSC provisions provided that the destination test is not satisfied with respect to property which is subject to any use, manufacture, assembly or other processing by any person between the time of the sale or lease by the seller or lessor and the delivery or ultimate delivery outside the U.S.
3. In a case decided under the DISC provisions, *General Electric v. Commissioner*, 245 F.3d 149 (2d Cir. 2001), the issue involved General Electric's sales of aircraft engines to Boeing which would then affix them to an airframe for delivery to the foreign customer. The court held that the engines were complete products and that they were fully assembled when they were sold by GE. Attaching the engines to the airframes did not change the result. The engines and airframes were physically separate and distinct from one another. The engines were routinely removed from one airframe and placed onto another. Thus, the engines were not subject to

use, manufacture, assembly or other processing between their first sale in the U.S. and their delivery outside of the U.S.

F. Foreign Related-Party Transactions. Section 250(b)(5)(C) contains special rules with respect to related-party transactions.

1. If property is sold to a related party who is not a United States person, the sale will not be treated as for a foreign use unless the property is ultimately sold by a related party, or used by a related party in connection with the property which is sold or the provision of services, to another person who is an unrelated person who is not a United States person and the taxpayer establishes to the satisfaction of the IRS that the property is for a foreign use.
2. The services rule's analog provides that services provided to a related person who is not in the U.S. do not qualify unless the taxpayer proves the service is not substantially similar to services provided by such related person to persons located in the U.S.

G. NYSBA Comments.

1. The New York State Bar Association Tax Section submitted a report on foreign derived intangible income ("FDII") providing recommendations on the determination of foreign branch income, allocation of costs, foreign-derived income from sales of property and services, consolidated return issues, income earned through partnerships, and the interaction between the FDII deduction and other tax code provisions.
2. The NYSBA requested guidance on determining the amount of business profits attributable to a foreign branch. One approach would be to follow the Treas. Reg. § 1.987-2 rules that attribute items to a QBU to the extent they are reflected on the QBU's separate books and records, as adjusted to conform to U.S. tax principles. An alternative would be to follow the dual consolidated loss provisions rules in Treas. Reg. § 1.1503(d)-5. The NYSBA recommends the separate books and records approach in the § 987 regulations.
3. An important issue in determining the amount of profits attributable to a foreign branch is how to treat items from transactions that are generally disregarded for U.S. tax purposes. The amount of foreign branch income can vary depending on whether disregarded transactions are taken into account or are disregarded.
4. The NYSBA believes that disregarded transactions should be taken into account for purposes of determining foreign branch income, in order to promote clear reflection of foreign branch income, and to create parity between the treatment of foreign branches and controlled foreign corporations.

5. The report stated that transfer pricing rules should be taken into account in determining foreign branch income and that the Authorized OECD Approach (“AOA”) for determining the profits provides one possible framework.
6. The rules for determining foreign branch income are relevant not only for computing the FDII deduction but also for computing the foreign tax credit limitation under § 904.
7. To compute deduction eligible income (“DEI”) and foreign derived deduction eligible income (“FDDEI”), a taxpayer must allocate its deductions among various items of gross income. However, the statute does not provide rules for identifying which deductions are properly allocable.
8. The NYSBA recommends a specific methodology for allocating and apportioning deductions in accordance with the principles of § 861.
9. Guidance is requested on when property is sold for foreign use and what constitutes use, consumption or disposition taking into account practical limitations on end user information. The NYSBA stated that guidance clarifying when property is sold for a foreign use is of paramount importance.
10. The “use, consumption, or disposition” terminology in the context of FDII is similar to terminology used in other provisions of the Code, such as in the definition of export income for a DISC (the “DISC rules”) and in the definition of “foreign base company sales income” (“FBC Sales Income”) for a CFC.
11. The NYSBA stated that the sale of inventory to a related foreign retailer to customers through stores located outside the United States should satisfy the requirement that the property is “ultimately sold...to another person who is an unrelated party who is not a United States person.” The NYSBA believes that there is sufficient authority to provide for a presumption that property sold to foreign retailers (whether or not related) is ultimately sold to unrelated foreign persons for a foreign use, notwithstanding the statutory language which appears to require tracing the ultimate users of property in the case of sales to related foreign persons. The presumption of foreign use could be rebutted to the extent that the domestic seller knew, or had reason to know, that a material amount of the goods was intended for resale in the United States.
12. Due to the likely difficulty in obtaining actual end user sale information from unrelated retailers, the NYSBA recommend that any additional documentation requirements be carefully crafted to allow compliance. For example, written confirmation from an unrelated foreign retailer that the

goods are intended for sale on websites that are not United States-facing or that substantially all of the sales are to non-United States persons should be sufficient.

13. For the sale of intermediate good to an unrelated foreign manufacturer, the NYSBA stated that the final destination of the finished product should not matter.
14. The NYSBA recommends anti-abuse rules to avoid the use of contract manufacturers or other intermediaries to improperly obtain an FDII deduction.
15. The NYSBA recommends that domestic sellers should be permitted to determine the location of sale of fungible goods on the basis of the overall proportion of goods sold.
16. In the case of intangible property that is sold or licensed to an unrelated foreign party for use in business operations conducted outside the United States, the NYSBA believes that it would be appropriate to have a presumption of foreign use that does not depend on whether the unrelated foreign party resells goods or performs services for United States persons.
17. Neither the statute nor the legislative history provides any specific guidance as to what it means to provide services to a person not located in the United States or with respect to property not located in the United States. Unlike in the sales context, there is little guidance governing when services are provided for foreign use or consumption. The report stated that income from services should be treated as foreign-derived if the services are actually consumed or used in a business outside the United States. However, the actual location of consumption or business use is not always readily observable, and so in such cases, proxies for the location of consumption or business use, based on information readily available to the taxpayer, should be used. The report stated that other sources of law, such as the OECD International VAT/GST Guidelines may be instructive.
18. The report recommends that Treasury adopt a pragmatic approach to determine the destination of business-to-consumer services on the basis of the customer's usual residence, as determined by reference to information routinely collected from the customer during the sales process.
19. The destination of business-to-business services should generally be determined by reference to the location of the customer's relevant place of business on the basis of the applicable business agreement unless a substantial amount (for example, 20%) of the value of the services is provided for the benefit of one or more related persons that are not party to that agreement. Guidance should require the taxpayer to treat each user as a customer and to allocate a portion of the services to them. Similarly, if a

taxpayer provides a services to a single customer with business establishments in multiple locations, guidance should require the taxpayer to attribute the services to the establishments that actually use the services, subject to a *de minimis* rule.

20. The NYSBA recommends that guidance clarify that income from services is generally foreign-derived if either (i) the services are provided to any person not located in the United States or (ii) the services are provided with respect to property not located in the United States.
21. Guidance was requested clarifying that income from the provision of services to an unrelated foreign intermediary that uses such services to produce consumer goods outside the United States or incorporates such services into the provision of additional services outside the United States should conclusively be presumed to be foreign-derived.
22. Guidance should also confirm that members of a consolidated group are treated as a single corporation for purposes of computing the FDII deduction.
23. The NYSBA requested guidance clarifying that income earned by a domestic corporation through a domestic or foreign partnership can qualify as foreign-derived in appropriate cases and that the FDII deduction is determined at the partner level.

V. BEAT.⁵

A. The § 59A base erosion and anti-abuse minimum tax (“BEAT”) provisions require an applicable taxpayer to pay a tax equal to the base erosion minimum tax amount for the tax year. The BEAT amount is the excess of 10% (5% for 2018) of the taxpayer’s modified taxable income (“MTI”) for the tax year over an amount equal to its regular tax liability for that year reduced by certain credits. MTI is the taxpayer’s taxable income increased by its base erosion payments (“BEPs”).

1. A BEP is any amount paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer for which a deduction is allowable. “Related person” is defined quite broadly to include any 25% owner of the taxpayer, any person who is related (within the meaning of § 267(b) or 707(b)(1)) to the taxpayer or any 25% owner of the taxpayer, and any other person who is related (within the meaning of § 482) to the taxpayer. BEPs include deductions arising from depreciable or amortizable assets acquired from such a related foreign person (note the issue regarding inbound IP).

⁵ Thanks to Tim Ng of Fenwick for his helpful comments.

2. BEPs do not include U.S.-source payments subject to gross-basis withholding and with respect to which the full 30% amount of tax has been withheld under §§ 1441 and 1442. A pro ration rule applies to the extent the rate of withholding tax is reduced pursuant to a treaty.
3. Exceptions apply for service payments charged at cost with no markup that are eligible for the services cost method under the § 482 transfer pricing regulations (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and for payments with respect to qualified derivatives. Certain other rules apply which we will not discuss here (for example, the BEAT rules apply to taxpayers that have annual gross receipts of at least \$500 million for the proceeding three years and a “base erosion percentage” of 3% or higher; special rules apply to expatriated entities; and special NOL rules apply).

B. Comments.

1. We have six general observations about these rules. **First**, the BEAT rules would seem more likely to apply to thin-margin taxpayers. For example, assume a U.S. company with \$100 of gross income, \$95 of deductions, and \$5 of taxable income. This will result in a tax of \$1 (using a 20% corporate tax rate for simplicity). If \$5 of the taxpayer’s deductions are BEPs, the taxpayer will have \$90 of deductions for calculating its MTI. Its MTI will be \$10. Assuming the full 10% tax rate, the taxpayer’s BEAT amount is zero (\$1 tentative minimum tax minus \$1 regular tax equals zero). While the taxpayer will not owe a minimum tax, it will be right on the threshold of owing this tax. Stated differently, in a simple example such as this one, the taxpayer can’t have BEPs that will reduce its taxable income by more than 50%. It’s pretty close in this example even with only a small amount of BEPs.
2. Now assume the taxpayer that has the same \$100 of gross income, but that it has \$50 of deductions and \$50 taxable income. Its regular tax liability is \$10 (assuming again for simplicity a 20% regular tax rate). If this taxpayer has \$5 of deductions that constitute BEPs, its deductions for minimum tax purposes are \$45. It will have \$55 of MTI and at 10%, no minimum tax (\$5.5 is less than \$10). This taxpayer is not subject to the base erosion minimum tax, and is not even close to the threshold. Again, stated differently, this taxpayer also cannot afford to have BEPs that will reduce its taxable income by more than 50%, but here the taxpayer is not even close to having a minimum tax liability. It has a very small amount of BEPs relative to its regular taxable income.
3. Our **second** observation: BEPs are amounts paid or accrued by the taxpayer to a foreign person which is a related party and with respect to which a deduction is allowable. Problem payments, or those which must

be considered, will likely primarily include payments for interest, royalties and services. If the taxpayer purchases goods from a foreign related party and resells those goods to customers, that transaction will generally not implicate the BEAT rules.

4. Income characterization might be important, however. Suppose in the previous example that the goods bear a trademark. Could an IRS examining agent assert that a portion of the amount paid to the foreign entity constitutes income properly characterized as a royalty? It would seem not. Rev. Rul. 75-254, 1975-1 C.B. 243, provides that the purchase of the goods bearing a trademark includes the right to resell the goods without having to pay a separate royalty. This assumes, of course, that the parties do not have a separate trademark agreement providing for a royalty. The same should be true regarding patented products.
5. The § 482 regulations are similar. They address imbedded-value transactions so that the value of the imbedded intangible can be considered, but they generally do not bifurcate the transaction. Further, the § 482 regulations also provide that the parties' written contracts should not be changed, modified, or ignored if the transactions satisfy the economic substance rules of Treas. Reg. §§ 1.482-1(d)(3)(ii)(B) and (iii)(B).
6. The income characterization rules in Treas. Reg. § 1.861-18 also could be important. Under those regulations, a software transaction might be characterized as the provision of services, a sale, or a license. This characterization could have significant consequences under BEAT provisions.
7. Sales commissions could be an issue. Assume a U.S. company pays selling commissions to foreign related parties, instead of selling the products to them and having them resell the products. The commissions would be a payment for services. See, for example, Rev. Rul. 60-55, 1960-1 C.B. 270. If the product were sold to the foreign related parties for resale, the U.S. company's transactions would be treated as sales transactions with no payment for services to the foreign party.
8. Another issue involves a U.S. company acting as a shared service provider for the worldwide group. For example, suppose that an Indian affiliate performs R&D services for a variety of entities in the corporate group, including foreign affiliates. For purposes of administrative convenience, the Indian affiliate has a single services agreement—with the U.S. parent. The U.S. parent then subcontracts the Indian affiliate's services throughout the worldwide group. The U.S. essentially acts as a mere conduit, but its payments to the Indian service provider in respect of services rendered to other foreign affiliates could raise BEAT issues. Risk here could be mitigated through amendments to the legal relationships

governing the shared services arrangement without upending the entire structure. VAT issues also might need to be considered.

9. Finally, there might be questions about what is properly subject to treatment as cost of goods sold. In the sales of goods/royalty example above but where a separate royalty is actually paid, perhaps the royalty could be charged to cost of goods sold instead of being claimed as a deduction.
10. Our **third** observation has to do with interest expense. This rule can produce surprises. Assume the U.S. taxpayer has \$100 of income for §163(j) purposes and has \$20 of interest expense owed to each of an unrelated bank and a foreign related person. The taxpayer's interest expense deduction is limited to \$30, thus \$10 is disallowed.
11. For BEAT purposes the \$10 of disallowed interest expense is taken from the \$20 of third-party (bank) interest expense. Thus, the full \$20 of related party interest expense is deductible and thus subject to the BEAT calculations.
12. **Fourth**, BEAT, of course, operates as a minimum tax. The amount is equal to 10% (5% in the case of taxable years beginning in calendar 2018) of the taxpayer's modified taxable income over the amount equal to the regular tax liability of that taxpayer. Thus, in principle, a taxpayer could have no Base Erosion Payments ("BEPs") subject to BEAT (but see below regarding BEAT's "off and on" switch) and still suffer the BEAT minimum tax if its regular tax liability, for example, were reduced by foreign tax credits. In this sense, BEAT has nothing to do with BEPs but rather operates as a true minimum tax. This certainly can sneak up on poorly advised taxpayers.
13. A **fifth** observation, which perhaps is particularly appropriate for taxpayers who are caught by the pure minimum-tax effect described above: BEAT has an "off and on" switch. It only applies to "applicable taxpayers," those that have average annual gross receipts for a three-year period exceeding a certain amount and that also have a base erosion percentage of at least 3% for the taxable year (2% for banks or registered securities dealers).
14. The BEAT switch thus is turned "on," and thus the BEAT rules apply, if the taxpayer has the tainted base erosion percentage or higher. If the taxpayer can keep its base erosion percentage below that amount, the BEAT rules are turned "off." Base erosion percentage is determined by dividing the taxpayer's BEPs by the amount of deductions allowable to the taxpayer for that taxable year.

15. Our **sixth** observation relates to the exception for amounts paid for certain services. Under § 59A(d)(5), *amounts* paid for certain services are not treated as BEPs. To qualify, (1) the *services* must meet the requirements for eligibility for use of the services cost method under § 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and (2) the *amount* must constitute the total services cost *with no markup component*.
16. An issue has arisen that, to some, involves a colloquy on the Senate floor. The question is, does BEAT apply to just the markup component of a marked-up service or to both the markup and the cost component of the payment? Assume that a U.S. taxpayer pays \$120 for services that include the cost to the provider of \$100 and a \$20 mark-up. Is \$120 or \$20 subject to BEAT? Assume that the services qualify under the services cost method, as modified for BEAT purposes, but that a markup was either required under those rules (Treas. Reg. § 1.482-9) or was added anyway.
17. One view is reflected in comments by Martin Sullivan. A conflicting view was expressed by Maral Corwin, Ron Dabrowski, Danielle Rolfes, Michael Plowgian, and Thomas Wessel of KPMG. A report by Ryan Finley at 2018 WTD 33-3 quotes Michael McDonald of EY as stating that despite disagreement on whether a markup disqualifies the entire charge for the BEAT services exception, the exception clearly covers the cost portion for qualifying services. A report by Alexander Lewis at 2018 WTD 33-2, quotes Mark Prater, Deputy Staff Director and Chief Tax Counsel for the Senate Finance Committee as stating that when you have a markup, there is a discussion and the legislation deals with no markup services. He states that this is clear. He also states there is a colloquy that was done on the Senate floor. He states that people should realize it is just a colloquy that discusses the issue but adds that if you look in the conference report language “I think it is pretty clear that it is the services with no markup that we’re talking about.”
18. While regulations will need to resolve the issue, we believe the matter is appropriately resolved without resort to the colloquy. In fact, the colloquy is irrelevant in our view. We think that the statute is clear: the § 59A(d)(5) exception applies to the *amount* that is without the “markup component” even if a markup amount also is billed.
19. We reach this conclusion based simply on general rules of statutory construction. The statutory exception is for an *amount*. It is an amount “with respect to” certain services. The “good services” are those that meet the requirements for eligibility for use of the services cost method under § 482 (but determined without regard to the requirement that the service does not contribute significantly to fundamental risks of business success or failure).

20. Under Treas. Reg. § 1.482-9, a markup would be required if the unmodified definition (as it appears in that regulation) required a markup. But § 59A still treats the cost amount of those services as an excepted amount. Section 59A has a different, modified definition. Section 59A(d)(5) also is pretty clear in stating that the excepted *amount* must constitute the total services cost with no markup *component*.
21. Thus, we don't think we need the colloquy to reach an answer. We think the statute is clear.
22. There is a lot of law on statutory interpretation but this issue seems like a pretty simple matter to resolve. Those who have expressed the view that the total amount of \$120 is disqualified from constituting an excepted service amount, and thus is a BEP, would render portions of the statute meaningless. They would render use of the words "amount" and "amounts" meaningless. The words "amount" or "amounts" appear in three places in § 59A(d)(5). Under basic rules of statutory construction, all words need to be given meaning.
23. Those who would subject the full \$120 to BEAT (as a BEP) also would render the parenthetical in § 59A(d)(5) meaningless since that parenthetical says those services are "good" services even though Treas. Reg. § 1.482-9 would always require a markup.
24. Section 59A(d)(5) also uses the word "component." One dictionary defines this term as "constituting a part or element of a larger whole; constituent." Thus, the statute pretty clearly contemplates a service charge with components, i.e., a cost amount and a markup component. The word "component" also cannot be ignored under basic rules of statutory construction.
25. Basic rules of statutory construction require a reading that does not nullify a portion of the statute. The statute intends to allow the exception for services that qualify for the services cost method *determined without* regard to one of the § 482 regulation's requirements. The statute says these are good services. They result in excepted amounts even if the § 482 regulations definition requires a markup. That is, the nature of the services exempts them.
26. Thus, we think that undue focus on the colloquy is misplaced and that a simple statutory analysis is all that is necessary. In the example above, the amount of \$100 should qualify for the exclusion from treatment as a BEP and only the \$20 should be treated as a BEP subject to the BEAT rules.
27. Those persons who would disagree with this conclusion would necessarily have to assume that the parenthetical was drafted by persons who didn't realize that it was irrelevant and had no meaning or effect. Statutory

draftspersons deserve more credit than that. When the parenthetical applies, a markup indeed is required. These doubters would have to say that Congress passed a law that, as to § 59A(d)(5)'s parenthetical clause, self-destructed in all cases. A markup is always required under Treas. Reg. § 1.482-9 in these cases. That's pretty simple.

28. The intent, and the clear statutory language, is to treat the *cost amount* of that "good" service as excepted from BEP treatment for BEAT purposes.

C. NYSBA Report on BEAT.

1. The NYSBA report on BEAT states that the statute contains certain ambiguities and inconsistencies that result in unintended consequences that may not successfully implement the legislative purpose. The NYSBA believes that Treasury has the authority to construe the statute to implement its legislative purpose in the regulations, even in the absence of literal statutory support.
2. Historically, base erosion provisions targeted deductible financial payments, which are highly portable and can be remitted across borders with little or no withholding tax. The NYSBA report notes that the BEAT includes a variety of other related party payments, including payments for tangible property and certain services, and applies even where transfer pricing standards are satisfied. As a result the BEAT is much more than a policing mechanisms for related party base eroding payments.
3. The report observes that the definition of Applicable Taxpayer focuses on gross receipts, which is not a measure of taxable income. Gross receipts have not been the subject of precise prior guidance and is not a measure of earnings for financial statement purposes. The NYSBA states that the use of gross receipts, rather than taxable income (the traditional measure of taxation), for purposes of the \$500 million threshold Applicable Taxpayer, will present challenges.
4. Since § 59A imposes the BEAT on each Applicable Taxpayer, the statute might literally be read as imposing a single tax on the entire controlled group. If the BEAT tax were imposed upon the controlled group as a whole, the report states that Beat would then need to be apportioned among the group members for liability and earnings and profits purposes.
5. The NYSBA believes that the intent of the provision is not to impose a single tax on the controlled group to then be apportioned. Rather, the provision is designed to say that all members of the controlled group should be aggregated. Individual corporations should bear their own BEAT tax based upon the corporation's or consolidated group's Base Erosion Tax Benefits. The BEAT tax calculated for the consolidated return group would be allocated among the individual members for

liability and earnings and profits purposes under the consolidated return rules for separate taxable income in Treas. Reg. § 1.1502-12.

6. The NYSBA states that the most obvious apportionment method would be to calculate each controlled group member's BEAT on a separate return basis and then to allocate the aggregate tax based upon the individual member's separate return tax. This method, at best, achieves the same result of applying the tax separately at the outset.
7. The aggregation rule included in the definition of Applicable Taxpayer significantly impacts the BEAT scope in terms of the gross receipts threshold. Consideration must be given to whether flows of goods, services and capital between various members of a controlled group should be eliminated or aggregated, and whether such amounts are counted only once as they leave the U.S. taxing jurisdiction or multiple times. Paragraph (3) says that "all persons treated as a single employer ... shall be treated as one person..." As a result, a payment from one member to another member would be disregarded as effectively a payment between branches of a single person. In the NYSBA's view, the intra-controlled group exclusion is appropriate in order to eliminate double counting of gross receipts for the BEAT.
8. The same aggregation rule under § 59A(e)(3) that applies for purposes of the gross receipts threshold is also applied for purposes of the Base Erosion Percentage threshold in subsection (c)(4). The NYSBA believes that the incorporation of the aggregation rule into § 59A(c)(4) makes sense only if the ECI Limitation also applies. Then payments to foreign affiliates not subject to U.S. tax – the actual Base Erosion Payments – would be properly identified.
9. Under subsection (d) of § 59A, a Base Erosion Payment is defined as an amount paid or accrued to a related foreign person. Curiously, the Base Erosion Payment definition does not have an aggregation rule. This inconsistency compounds when Base Erosion Payments are considered in the calculation of Modified Taxable Income. The Base Erosion Percentage applicable to NOLs is calculated with the intra-controlled group exclusion, while literally the Base Erosion Payments for the current year is calculation without the intra-controlled group exclusion. The NYSBA recommends guidance interpreting the Base Erosion Payment definition to incorporate both the intra-controlled group exclusion and the ECI Limitation. Without such guidance, the statute does not operate properly.
10. The scope of the related party rules may frequently exceed the scope of information access. The NYSBA recommends reporting requirements be added to § 6038A(b) to permit taxpayers to demonstrate inaccessibility in certain lesser relationship contexts.

11. In terms of branch ECI, the NYSBA report recommends guidance interpreting the statute to disregard ECI payments received by a U.S. branch of a foreign corporation that is not a member of the payor's controlled group.
12. On the services markup issue, a substantial majority of the NYSBA does not believe that the permitted exclusion of service cost method cost from the definition of Base Erosion Payments should be lost entirely merely because there is a profit element in excess of the actual cost. Generally, tax legislation attempts to avoid such a "cliff" effect that chills otherwise permissible behavior.
13. The NYSBA recommends that the SCM exclusion be construed to mean that the actual cost element of services compensation is to be treated as excludable from Base Erosion Payments and the possibility of an additional profit component should not negate the exclusion treatment of such cost "amount."
14. The NYSBA report recommends regulations to coordinate BEAT with taxes paid under Subpart F and GILTI. The BEAT statute itself does provide an exclusion for payments to a CFC even if a simultaneous Subpart F inclusion or GILTI is required. The NYSBA recommends excluding such payments if the taxpayer identifies the recipient CFC, elects to exclude the payments from Base Erosion Payments and Base Erosion Tax Benefits, and the payor-taxpayer includes the payments in income.
15. The NYSBA report discusses a number of qualified derivatives issues including the qualified derivative payment exemption (the "QDP Exemption").
16. In terms of interest deductions of branches, the NYSBA believes that Branch Interest expense is treated as paid to the branch's creditor for purposes of § 59A.
17. The NYSBA believes that Treas. Reg. § 1.882-5 excess interest should not be entirely exempt from BEAT. Rather, excess interest should be treated as an allocation or apportionment of a ratable portion of the foreign corporation's third-party interest expense to its ECI activities.
18. The NYSBA recommends that interest deductions under the authorized OECD approach ("AOA"), exceeding the deductions on branch booked liabilities, are to be treated in the same manner as excess interest under Treas. Reg. § 1.882-5 for BEAT purposes.
19. The BEAT is applicable to corporations and groups of corporations but is generally silent as to its application to partnerships. In the NYSBA's view, treating a partnership as an aggregate for purposes of § 59A and

testing gross receipts, Base Erosion Percentage and Base Erosion Payments at the partner level (and not at the partnership level) seems consistent with the purpose of the statute.

20. For any § 59A anti-conduit regulations, the NYSBA recommends including a provision addressing the use of multiple entities so that if a payee unrelated party has a payable to a second unrelated party, the IRS may continue to follow the chain until it finds a payable to a party related to the original U.S. payor. The rebuttable presumption approach could potentially be useful to allow taxpayers to show that in coincidental circumstances, if no plan of avoidance existed then the payment should not be considered base eroding.
21. The NYSBA recommends regulations eliminating the application of § 59A for certain transactions that are effectively conduit transactions, even between related parties.
22. The appropriate interpretation of the phrase “taxable income ... determined without regard to” is unclear. One interpretation would determine Modified Taxable Income by merely adding back to taxable income the BEAT Deduction (the “Top-Up Approach”). Another interpretation would determine Modified Taxable Income by recalculating taxable income as though the BEAT Deductions did not exist (the “Recalculation Approach”). Which approach is adopted can have a significant impact on both the complexity and amount of the BEAT. In general, the Top-Up Approach is likely to result in less complexity and, in many cases, a greater BEAT liability as compared to the Recalculation Approach.
23. As a policy and conceptual matter, the NYSBA believes that the Recalculation Approach is an appealing approach because only with a true “with and without” calculation can the base erosion impact be measured. The Recalculation Approach would generally allow NOLs to be used more rapidly. If the Top-Up Approach is adopted, there is an issue as to how to calculate Modified Taxable Income if there is a loss in the year in question.
24. The NYSBA states that the language in § 59A(c)(1)(B) raises the question of whether the Base Erosion Percentage of any NOL is determined with respect to the year of its origination or the year of its utilization. The NYSBA believes the grammatically correct reading is that its Modified Taxable Income for the year is calculated without the relevant amount of NOL deduction allowed for the same year. This interpretation is supported by the fact that § 59A(c)(4)(B) explicitly excludes the NOL deduction in the calculation of Base Erosion Percentage, suggesting that NOLs imported into the year have a different Base Erosion Percentage than the Base Erosion Percentage for the year of utilization.

25. Regulations should clarify whether taxpayers with NOLs from years not treated as subject to the BEAT have a Base Erosion Percentage.
26. The statute does not specify how § 163(j) deferred interest carryforwards are to be treated for BEAT purposes. The NYSBA report rates that this raises the question of how the carryforward should be taken into account in calculating Modified Taxable Income.

VI. PARTNERSHIP WITHHOLDING.

A. Sale of Partnership Interest.

1. The Tax Reform Act (2017 Act) overturned *Grecian Magnesite v. Commissioner* (below), which held that the sale by a foreign person of its interest in a partnership engaged in a U.S. trade or business was not subject to U.S. tax. The 2017 Act added new § 864(c)(8), providing that if a non-resident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership that is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as income that is effectively connected with the conduct of a U.S. trade or business (ECI). This is the end result that the IRS advocated in Rev. Rul. 91-32. The IRS lost in court, but the result the IRS wanted is now codified.
2. The amount of gain or loss that is ECI is (i) the portion of the partner's distributive share of the amount of gain or loss that would have been ECI, if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest or (ii) zero, if no gain or loss on such deemed sale would have been ECI.
3. The status of the partnership as U.S. or foreign does not matter; the relevant point is whether the partnership is engaged in a U.S. trade or business.
4. A partner's distributive share of gain or loss on the deemed sale is determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.
5. New § 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under new § 864(c)(8) as effectively connected with the conduct of a trade or business within the U.S. ("effectively connected gain"), then the transferee must withhold a tax equal to 10 percent of the amount realized on the disposition. Future guidance will be issued on how to withhold, deposit, and report the tax withheld.
6. Presumably these new withholding rules will use the FIRPTA rules as a precedent, in which the purchaser of a U.S. real property interest from a

non-resident seller must withhold 10 percent of the purchase price. The FIRPTA rules contain an exemption to the extent the seller can demonstrate the withholding of 10 percent of the purchase price would exceed the seller's tax on the disposition.

7. Absent rules under section 1446, as a matter of prudence presumably buyers will withhold whenever there is a foreign seller of a partnership interest.
8. Further, the partnership will need to exercise caution that is not treated as a "backup" withholding agent. § 1446(f)(4).
9. While a seller can provide a "non-foreign affidavit" to certify that he is not a foreign person (and thus avoid withholding), § 1446(f), the statute does not provide for a certification that the partnership does not have a U.S. trade or business. Hopefully, regulations will authorize such an exception from withholding.
10. In addition, commentators expressed concern that in the case of a disposition of a publicly traded partnership interest, applying new § 1446(f) presents significant practical problems. In response, Treasury and the IRS determined that withholding under § 1446(f) is not required for any disposition of an interest in a publicly traded partnership until regulations or other guidance has been issued (see below). The temporary suspension is limited to dispositions of interest that are publicly traded and does not extend to non-publicly traded interests.

B. Notice 2018-29: Non-publicly traded partnerships.

1. There's no need to withhold if:
 - (a) The transferor certifies that for each of the past three years the transferor was a partner for the full year and that the transferor's ECI was less than 25% of the transferor's total income for the partnership (this only applies to sales, not distributions), or
 - (b) The partnership certifies that its ECI (including FIRPTA gain) under § 964(c)(8) would be less than 25% of the total gain on the deemed sale of all its assets. The certification must be issued no earlier than 30 days before the transaction.
2. Withholding also is not required if:
 - (a) The transferor certifies that the disposition will not result in gain (for example, it had a loss), or
 - (b) The transferor has no recognized gain (*i.e.*, in a nonrecognition transaction), at least until further study by Treasury and the IRS.

3. The transferor may rely on a transferor's most recently issued K-1 for determining liabilities in addressing the transferor's gain, or, alternatively, a certification from the partnership.
4. In the case of a distribution by the partnership, the partnership is permitted to rely on its books and records, or on a certification from the distributee partner, to determine whether a distribution exceeds the partner's basis.
5. The total amount of withholding is generally limited to the amount of cash and property to be transferred (other than in related-party transactions and partnership distributions).
6. Forms and procedures applicable under § 1445 (FIRPTA) apply for depositing the withheld funds. The transferor's non-foreign affidavit also is as provided under the § 1445 regulations.
7. The § 1446(f)(4) rules that can make a partnership liable for tax not withheld by the transferee are suspended until regulations or other guidance is issued.
8. Tiered partnership issues will be addressed in future regulations on a look-through basis.

C. Determining the Taxable Amount.

1. New § 864(c)(8) applies when foreign person sells, exchanges or otherwise disposes of a partnership interest in a partnership that is engaged in a U.S. trade or business.
2. The partnership is deemed to have sold all of its assets under § 864(c)(8)(B) and the hypothetical gain on that sale must be analyzed to determine what portion of that gain, if any, would have been effectively connected with the conduct of a trade or business in the U.S. (ECI).
3. Section 865 needs to be considered in determining the source of the hypothetical gain. Under § 865(i)(5), the § 865 source rules are applied at the partner level. In this case the partner will be a foreign person.
4. Section 865(d) applies to intangibles, the gain on the deemed sale of which likely initially will be foreign source income (with a special rule for goodwill which looks to where the goodwill was "generated").
5. Section 865(e)(2) can cause the gain, initially treated as foreign source gain in the case of non-goodwill intangibles, to be characterized as U.S. source income if it is "attributable" to a U.S. office of the foreign person under the principles of § 864(c)(5). § 865(e)(3).

6. This was an issue addressed in *Grecian Magnesite Mining* (below), although in the context of the sale of a partnership interest whereas under § 864(c)(8) it would need to be addressed in the context of the hypothetical sale by the partnership of all of its assets.
7. Section 865(h) also provides a treaty election to characterize the gain on the sale of an intangible (including goodwill) that otherwise would be U.S. source income as foreign source income if a treaty would apply to treat it as foreign source income. Perhaps any such treaty should override the Code without the need for the election if the treaty post-dates the enactment of § 865 (1986).
8. To the extent the gain on the hypothetical sale of the partnership's assets constitutes foreign source income, it would seem not to constitute ECI. *See* § 864(c)(4). The flush language in § 864(c)(4)(B), however, should be considered (although if applicable, § 865(e)(2) presumably would have made the income U.S. source income).
9. If the hypothetical gain is U.S. source income from the sale of a capital asset, § 864(c)(2) provides rules to determine whether the gain is ECI. Other U.S. source gain likely is ECI under § 864(c)(3).
10. Real property is subject to FIRPTA. § 864(c)(8)(C).
11. The gain on the sale of the partner's partnership interest is ECI to the extent it does not exceed the partner's distributive share of the deemed-sale ECI amount.
12. These rules might be helpful regarding the partnership certification discussed above concerning less than 25% of the deemed-sale gain constituting ECI.

D. Grecian Magnesite Mining – Rev. Rul. 91-32 Rejected.

1. *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017), addressed *Grecian Magnesite Mining* (“GMM”), a Greek corporation that purchased an interest in Premier Chemicals LLC (“Partnership”) a U.S. limited liability company treated as a partnership for tax purposes. The Partnership is in the business of extracting, producing, and distributing magnesite which it mines or extracts in the United States. GMM's partnership interest was later redeemed. Part of the gain was subject to tax under FIRPTA rules. The issue was how the rest of the gain from the redemption of GMM's partnership interest should be taxed.
2. Under Rev. Rul. 91-32 the gain recognized by GMM would be effectively connected with a U.S. trade or business to the extent the partnership is so engaged. The Tax Court rejected the revenue ruling as not an interpretation of the IRS's own regulations, and stated that it lacked the

power to persuade the court. Further, the court stated that the revenue ruling's treatment of the relevant partnership statutory provisions was cursory in the extreme, and did not even cite § 731, which yields a conclusion of "gain or loss from the sale or exchange of a partnership interest." The court stated that the ruling's Subchapter K analysis essentially begins and ends with the observation that "Subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships." The court declined to defer to the ruling, and stated that instead it would follow the Code and the regulations to determine whether the disputed gain was effectively connected income.

3. This holding was not unexpected. Many practitioners have long viewed the revenue ruling as suspect and of questionable validity. It simply ignored the Code's statutory language, discussed immediately below.
4. The court stated that the case arises at the intersection of two areas of tax law: *i.e.*, partnership taxation and the U.S. taxation of international transactions. Under the partnership rules, when a partnership redeems a partner's interest in the partnership by making a payment to the partner, § 736(b)(1) provides that the liquating payments "be considered as a distribution by the partnership and not as a distributive share [of profits]." Section 731(a) in turn provides: "In the case of a distribution by a partnership to a partner ... any gain recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Section 741 provides, as a general rule, that "In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset."
5. The court stated that the statute does suggest that, in the context of the transaction at issue, the partnership is conceived of as an entity distinct from the individual partners, and the partner pays tax on the sale of its partnership interest in a manner broadly similar to the manner in which it might pay tax on the sale of an interest in a corporation.
6. FIRPTA contains an exception to this rule. Section 897(g) and its regulations provide that the amount of any money and the fair market value of any property received by a foreign person in exchange for a partnership, trust, or estate interest shall to the extent attributable to United States real property interest, be considered an amount received from the sale or exchange of such property in the United States. Part of GMM's gain was attributable to U.S. real property interests and thus was taxable income to that extent. The FIRPTA provisions were not in issue; the issue involved the gain amount in excess of the FIRPTA gain.

7. The court found that the balance of the gain was treated as gain from the sale or exchange of a capital asset based on the plain language of the statute itself. The court stated that Congress intended § 741, if applicable, to provide capital gain or loss treatment on the sale or exchange of a partnership interest by a partner. Indeed, stated the court, congressional use of the phrase “shall be considered as” in § 741 is unambiguous and mandatory on its face.
8. The court stated that the Service cited no authority to shortcut or distort the Subchapter K analysis by invoking a purpose an argument from Subchapter N. The court said that it rejected that same argument 38 years ago.
9. Having addressed the Subchapter K partnership rules and having rejected Rev. Rul. 91-32, the court then addressed the Code’s international tax provisions. Section 865(a) and its default rule treats the disputed gain as foreign source income. The Service argued however that the disputed gain falls under an exception to the default rule, namely, the “U.S. Office” rule of § 865(e)(2)(A) which provides that “If a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such office or fixed place of business shall be sourced in the United States.”
10. The Service argued that the disputed gain would be taxable under this exception if the gain was attributed to the Partnership’s office.
11. Section 865(e)(3) provides that in order to determine whether income from a sale or exchange is attributable to a U.S. office or fixed place of business, “the principles of § 864(c)(5)” apply. Under § 864(c)(5)(B), income, gain, or loss is attributable to a U.S. office only if: (a) the U.S. office is a material factor in the production of the income, and (b) the U.S. office regularly carries on activities of the type from which the income, gain, or loss is derived. Treas. Reg. § 1.864-6 refers to the two elements together as the “material factor” test and “regularly carries on activities of the type” as “realized in the ordinary course.”
12. Thus, the Service’s argument had two strands: first, that the Partnership’s office was material to the deemed sale of GMM’s portion of the Partnership assets; and second, that the Partnership’s office was material to the increased value of that interest that GMM realized in the redemption. The court stated that the material factor test was not satisfied because the Partnership’s actions to increase its overall value were not “an essential economic element in the realization of the income.” Increasing the value of the Partnership’s business as a going concern, without a subsequent sale, would not have resulted in the realization of gain by GMM.

13. Even if the court were to decide that the Partnership's office was a material factor in the production of the disputed gain (which it did not), the court stated that it would also need to find that the disputed gain was realized in the ordinary course of the Partnership's business conducted through its office in order for the gain to be attributable to that office, and thereby to be U.S. source income.
14. According to GMM, the redemption of its interest in the Partnership was a one-time, extraordinary event and therefore was not undertaken in the ordinary course of the Partnership's business. The Service pointed to the Partnership's other actions to show that the Partnership's redemption of GMM's interest was not an isolated event. The court stated that the Service conflates the ongoing income-producing activities of the Partnership (Magnesite production and sale), which certainly occurred in the ordinary course, and the redemption of GMM's partnership interest, which was an extraordinary event. The court stated that the Service would effectively eliminate the "ordinary course" test and would allow the "material factor" test to stand for both tests.
15. Finally, the court rejected penalties asserted on the FIRPTA portion of the redemption proceeds. The taxpayer is a Greek corporation staffed by management personnel not familiar with the U.S. tax laws, and had a U.S. attorney who recommended a U.S. tax attorney/CPA. GMM relied completely on the tax advisor to prepare its tax returns. Thus, GMM had reasonable cause for its failure to report the FIRPTA gain on its return.
16. The Tax Reform Act effectively repealed *Grecian's* holding, as discussed above. The IRS also appealed *Grecian* despite the Tax Act's changing the law on this issue.
17. Note that *Grecian's* Nos. 11-15 above continue to have applicability.

E. Publicly-Traded Partnership Interests.

1. In Notice 2018-8, Treasury and the IRS temporarily suspended withholding obligations under new § 446(f) for dispositions of some publicly-traded partnership interests.
2. The Notice was issued in response to newly enacted §§ 864(c)(8) and 1446(f). New § 864(c)(8) provides that a nonresident alien individual's or foreign corporation's gain or loss from the sale, exchange, or other disposition of a partnership interest is effectively connected with the conduct of a trade or business in the U.S. to the extent that the person would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value.
3. New § 1446(f)(1) provides that if any portion of the gain on any disposition of an interest in a partnership would be treated under new

§ 864(c)(8) as effectively connected with the conduct of a trade or business within the U.S. (“effectively connected gain”), then the transferee must withhold a tax equal to 10 percent of the amount realized on the disposition. Future guidance will be issued on how to withhold, deposit, and report the tax withheld.

4. Commentators expressed concern that in the case of a disposition of a publicly traded partnership interest, applying new § 1446(f) presents significant practical problems. In response, Treasury and the IRS determined that withholding under § 1446(f) is not required for any disposition of an interest in a publicly traded partnership until regulations or other guidance has been issued. The temporary suspension is limited to dispositions of interest that are publicly traded and does not extend to non-publicly traded interests.
5. Comments were requested on the application of § 1446(f) to interests in publicly traded partnerships, rules for determining the amount realized taking into account § 752(d), procedures for requesting a reduced amount required to be withheld, whether a temporary suspension of § 1446(f) for partnership interests that are not publicly traded partnership interests is needed, and what additional guidance, or forms and instructions, may be needed to help taxpayers apply §§ 864(c)(8) and 1446(f).

VII. SECTION 163(j).

A. Section 163(j) Guidance.

1. The IRS provided initial helpful guidance on § 163(j) in Notice 2018-28. The Notice states that regulations will be issued clarifying that for a C corporation all interest will be business interest and all gross interest income will be business interest income.
2. Regulations will also be issued to clarify that the § 163(j) limitation applies at the consolidated group level. However, the § 163(j) regulations will not treat an affiliated group that does not file a consolidated return as a single taxpayer.
3. The Notice states that regulations will also address other consolidated group issues, including: the allocation among group members; the treatment of disallowed interest deduction carryforwards when a member joins or leaves the group; including whether such carryforwards are subject to a separate return limitation year (“SRLY”) limitation; the application of the § 1.1502-32 basis adjustment rules to disallowed interest deductions; and the application when one or more consolidated group member that conducts an exempt business described in new § 163(j)(7)(A)(ii), (iii), or (iv). However, the Notice does not provide any

indication of how the new regulations will address these important consolidated return issues.

4. The Notice also states that regulations will be issued clarifying that the disallowance and carryforward of a deduction will not affect whether or when such business interest expense reduces earnings and profits.
5. Regulations will also provide that a partner cannot include its share of business interest income except to the extent of its share of the excess of (i) the partnership's business interest income over (ii) the partnership's business interest expense (not including floor plan financing) and will also provide that a partner cannot include its share of the partnership's floor plan financing interest in determining the partner's annual business interest expense deduction limitation. New regulations will be issued to prevent partnerships from getting a double counting of business interest income and floor plan financing interest for purposes of the § 163(j) deduction.

B. NYS Bar Association Comments.

1. The New York State Bar Association ("NYSBA") issued a report on § 163(j) less than a week before the Notice was released. The report asked for guidance on the issues covered in the Notice, in addition to a number of other issues not addressed in the Notice.
2. The NYSBA requested guidance that the term "interest" include any item of income or expense that is treated as interest under the Code and that if the government seeks to treat items economically equivalent to interest as interest for purposes for purposes of § 163(j) that such guidance apply only to a limited set of specifically identified types of transactions.
3. The NYSBA recommends that interest expense that was disallowed under old § 163(j) should be carried forward and treated as interest paid or accrued by the taxpayer in the first year new § 163(j) is effective.
4. The NYSBA also requests guidance on the coordination of § 163(j) with other deduction rules. Even though § 163(j) is applied before BEAT, so that there is the maximum possible disallowance of interest, this should not be seen as suggesting a broader approach to how § 163(j) should be coordinated with other interest deductibility limits.
5. Guidance was also requested on whether a corporation that undergoes an ownership change under § 382 is treated as using its carryforwards of disallowed business interest expense before it uses other tax attributes limited by §§ 382 and 383.
6. The NYSBA stated that the report does not represent all the significant issues raised by § 163(j).

C. Section 163(j) at the CFC Level.

1. The NYSBA states that it appears a U.S. shareholder's computation of its Subpart F income will be impacted by application of § 163(j) to the CFC's interest expense, unless guidance provides relief from that result. However, it is not entirely clear that it makes sense for § 163(j) to apply to a CFC's interest expense, for purposes of computing Subpart F income.
2. In the proposed regulations under the previous version of § 163(j), Treasury and the IRS decided not to apply the statutory limitation to the interest expense of any foreign corporation (including a CFC) that did not conduct a U.S. trade or business. The preamble stated that "The disallowance rules do not apply if the payor corporation is either an S corporation or a foreign corporation (except as provided under § 1.163(j)-8, related to a foreign corporations with effectively connected income).
3. In the absence of similar guidance under new § 163(j), the NYSBA says that it appears the provision would apply to CFCs. Pursuant to § 954(b)(5), when a CFC has foreign base company income, that income is reduced by "deductions ... properly allocable to such income" (including interest expense) for purposes of computing the amount of a U.S. shareholder's income inclusion under § 951. For this purpose, a CFC computes the amounts of its items of income and deduction under largely the same U.S. federal income tax principles as apply to determine the taxable income.
4. The NYSBA stated that it intended to submit separate comments on the provisions of the Act that deal with GILTI, including § 163(j). In its subsequent GILTI report, the NYSBA favors applying § 163(j) at the CFC level for GILTI calculation purposes.

D. Comments.

1. The U.S. Chamber of Commerce also submitted comments to the IRS on Notice 2018-28, A. above. Notice 2018-28 provides guidance on § 163(j) and requested comments on a number of issues. The Chamber identifies issues arising under Notice 2018-28 and provides suggested solutions.
2. The first issue the Chamber addresses is the fact that the statutory language is unclear with respect to the classification of property contributed by corporations to a partnership as trade or business income or as investment income. The legislative history makes it clear that Congress intended that all income of a corporation qualifies as trade or business income. However, it is less clear whether income from those assets may become investment income in the hands of a partnership following its contribution by the corporation. The Chamber does not believe that Congress intended to provide corporations with the flexibility to treat

income that would otherwise be trade or business income as investment income by transferring the assets producing that income to a partnership. The Chamber recommends that it be made clear that property contributed by a corporation to a partnership whose interests are owned be characterized as trade or business income in the hands of the partnership.

3. The Chamber further recommends an election for businesses operating in the United States with more than one U.S. taxpayer (*e.g.*, multiple consolidated groups, deconsolidated entities) to apply § 163(j) on an expanded affiliated group basis using the rules under the proposed regulations. Prior to tax reform, IRS rules allowed U.S. businesses to apply § 163(j) on an expanded affiliated group basis.
4. The Chamber states that applying § 163(j) on a single consolidated basis will divorce the tax calculation from economic realities of determining debt capacity, which is based on the entire U.S. operations/assets and not to the particular taxpayer incurring the debt. In terms of the application of § 163(j) to intercompany debt, the Chamber recommends disregarding debt between a partnership and partners where the partnership is wholly-owned by members of the same consolidated group. Debt between a partnership and partners where the partnership is wholly-owned by members of the same consolidated group should also be disregarded when determining the limitation.
5. When all the beneficial owners of a non-corporate entity (such as a partnership) are C corporations, the Chamber also recommends that all interest paid, accrued, or includible in gross income by such non-corporate entity is business interest and business interest income. A C corporation's portion should always be business interest by stating that interest expense and income allocated to a corporate partner of a partnership is business interest and business income, in order to be consistent with the characterization where a corporation pays, accrues, or includes such amounts directly.

VIII. FOREIGN TAX CREDIT ISSUES POST-TRA.

- A. Several developments in the Tax Act will make foreign tax credit planning, and related source of income and allocation of expense questions, more important and challenging in the new regime:
 1. The new lower US corporate tax rate of 21%, together with the reduced rates of 10.5% on GILTI and 13.125% on FDII, will cause more taxpayers to be in an excess credit position. The expansion of § 904(d) to four primary baskets, coupled with the lack of any FTC carryovers or carrybacks in the GILTI basket, will further exacerbate FTC utilization issues.

2. Changes to the source of income and expense allocation rules will require taxpayers to find new ways to generate low-taxed foreign source income to the extent that excess credits are generated in the general basket.
3. Repeal of the FTC pooling rules of § 902, and replacement with an annual FTC under new § 960, will make timing differences more significant and potentially hazardous.
4. Significant parts of the work in building a new foreign tax regime were delegated to IRS and Treasury through rule making. It is unclear to what extent regulations will simply adopt and adapt existing principles, or start from a new foundation. For example, how will taxes “properly attributable to” GILTI tested income or subpart F income be determined? Will the § 904(d) look through rules be retained so that related party interest and royalties remain general basket income? Will rules for allocation of interest expense and R&D expense under § 1.861-8 through -17 be substantially revised and how, if at all, will they apply to income included under GILTI? Many of these questions remain unanswered pending regulations.
5. Anti-abuse rules, such as § 901(m) and § 909 remain in place and continue to potentially be relevant after the Act.

B. Under the Act, a US taxpayer’s income directly earned from foreign sources should fall within the one of the following three categories:

1. Branch income. Income earned through a foreign disregarded entity (DRE) or other foreign branch or flow-through entity will generally be subject to full 21% US corporate tax. A separate § 904(d) basket is created for all of the taxpayer’s foreign branches. *See* Foreign Branch income below. By definition, income earned through a foreign branch cannot qualify for the § 250 deduction attributable to FDII. *See* § 250(b)(3)(A)(i)(VI).
2. FDII. Income from direct sales of goods or services not effected through a foreign branch will qualify as FDII and be eligible for the reduced rate of tax under § 250. In the case of property sales, the source of this income will turn on whether the taxpayer produces or merely purchases inventory. FDII typically would fall within the general basket. Assuming the § 250 deduction is allocated directly against FDII for § 861 purposes, the FTC limitation associated with the general basket will be reduced to the extent of the taxpayer’s foreign-source FDII.
3. Other General Basket Income. It is possible that the taxpayer may earn other foreign source income that is general basket income, but also is not FDII. This will typically fall within the general basket and be subject to the normal 21% corporate rate. For example, depending on the fate of the

look-through rules of § 904(d), interest or royalties paid by CFCs to the US taxpayer may continue to be general basket foreign source income.

C. Foreign Branch Income.

1. Section 14302 of the Act creates a new category of “foreign branch income,” defined by new § 904(d)(2)(J) as follows—

“the business profits such United States person which are attributable to 1 or more qualified business units (as defined in Section 989(a)) in 1 or more foreign countries. ... the amount of business profits attributable to a qualified business shall be determined under rules established by the Secretary.”

2. Passive basket income is excluded from foreign branch income. *See* § 904(b)(2)(J)(ii). In the case of high-taxed passive basket income earned through a branch, query whether the high-tax kick out will treat this as general basket income or simply leave such income in the branch category.
3. The creation of a single category of “foreign branch income” that refers to *1 or more* qualified business units in *1 or more* foreign countries seems to combine all branches of the US taxpayer in a single § 904(d) basket. This would permit cross-crediting between high-taxed and low-taxed branches, but not against other low-taxed income.⁶
4. In light of the full US tax rates applicable to foreign branches, as well as the continued availability of foreign branch losses to offset US source income, it can be expected that the branch basket will be relatively high-taxed. Therefore, taxpayers may have an incentive in some cases to earn low-taxed income into foreign branch entities to obtain utilization of credits within that basket.
5. Earning income through a foreign branch will be less desirable than earning FDII or earning income through a CFC, however, due to the full US corporate rates that apply to branch income. Even a taxpayer with a high rate of foreign tax may find it more advantageous to structure into earning subpart F income, rather than branch income, due to the availability of the high-taxed election of § 954(b)(4).
6. “Attributable To.” As noted above, the Act delegates to regulations the process of writing rules to determine income “attributable to” a foreign branch. In the absence of regulations, the existing dual consolidated loss

⁶ The Conference Report explains that the creation of a branch category was intended to prevent cross-crediting against low-taxed foreign income of the taxpayer in light of the increased incentives under the participation exemption to shift income to low-taxed jurisdictions overseas. Conf. Rep. at p. 393.

(DCL) regulations might be consulted for guidance. Treas. Reg. § 1.1503(d)-5. These regulations generally look to the books and records of a DRE to determine attribution of a DRE's items, and in the case of a "true" branch, apply US ECI concepts to attribute items to the branch.

7. The "attributable to" definition in the branch basket rule raises several questions about attribution of income and expense to a branch. Fundamentally, one basic issue concerns the allocation of income between the branch basket and US office in the case of a disregarded entity that performs integrated functions with the parent.
8. For example, USP owns a German GmbH engaged in a manufacturing business in Germany that has elected to be treated as a disregarded entity (DRE). GmbH is engaged in the manufacture and sale of product that is produced and then sold to USP for distribution in the United States. GmbH sells the product to USP for \$100, which then resells the product in the US for \$120. From a German tax perspective, \$100 of gross income is attributable to the GmbH and subject to German tax. From a US tax perspective, USP has \$120 of income from the sale of property manufactured outside of the United States.
9. For § 904 foreign tax credit purposes, how much of USP's \$120 of foreign source income is attributable to the branch basket and how much of the foreign source income is foreign source general basket income under § 863(b)?
10. Other branch basket attribution questions may also arise. For example, how should gain or loss on a sale of a branch be treated? Will the DCL regulations' "push-down" rule, which treats gain or loss on sale of a DRE as attributable to the DRE itself, be applied for purposes of § 904(d)(2)(J)? Further, a disregarded entity classified as a branch may make a dividend that is subject to foreign withholding taxes despite not generating regarded income for US tax purposes. Are withholding taxes associated with a distribution out of a disregarded entity "attributable" to the branch and thus allocated to the branch basket? Compare Treas. Reg. § 1.1503(d)-5(c)(4)(v) (providing that § 987 gain or loss recognized on a remittance from a separate unit is not considered to be "attributable to" the separate unit for DCL purposes). Alternatively, are branch withholding taxes allocable to the general basket under the base differences rule as applied under prior law? See § 904(d)(2)(H) and Treas. Reg. § 1.904-6(a)(1)(iv). Reg. § 1.1503(d)-5(c)(4)(iii).
11. Further, a disregarded entity classified as a branch may make a dividend that is subject to foreign withholding taxes despite not generating regarded income for US tax purposes. Are withholding taxes associated with a distribution out of a disregarded entity "attributable" to the branch and thus allocated to the branch basket? Compare Treas. Reg. § 1.1503(d)-

5(c)(4)(v) (providing that § 987 gain or loss recognized on a remittance from a separate unit is not considered to be “attributable to” the separate unit for DCL purposes). Alternatively, are branch withholding taxes allocable to the general basket under the base differences rule as applied under prior law? *See* § 904(d)(2)(H) and Treas. Reg. § 1.904-6(a)(1)(iv).

12. Partnerships. The treatment of partnership income as generating foreign branch income or general basket income will be an important issue. In light of the application of the participation exemption of § 245A, but not GILTI, to a foreign corporation that is a “10/50” company, there may be more incentive for US corporations to structure foreign joint ventures as corporations rather than flow-through entities in the future.
13. Mechanically, the branch basket was added to the Code as a new paragraph 904(d)(1)(B). This subsection formerly referred to the general basket, and the Act fails to correct certain cross-references to the general basket. *See, e.g.*, § 904(d)(2)(H) (providing that taxes imposed with respect to a base difference item are allocated to paragraph (d)(1)(B)). Barring Technical Corrections legislation, it remains to be seen how such patent drafting errors should be interpreted.

D. Repeal of Section 863(b) / 50-50 Rule.

1. In the case of inventory produced by the taxpayer within the US and sold outside the United States (or vice versa), Congress modified § 863(b) to provide that such income is sourced solely to the place of production. *See* Act § 14304. The Committee explains that such change is intended to modernize export sourcing in connection with the new lower rates of tax on foreign source income. Much if not all income described in § 863(b) earned by a US taxpayer would be FDII. It has been stated by IRS official informally that they understand FDII serves as a replacement for the export incentive created by old § 863(b).
2. This change repeals one of the main sources of foreign general basket income. Interestingly, the change was scored as raising only \$500 million of revenue over the next 10 years. On the inbound side, this rule change would allow many foreign producers of imported property to pass title within the United States without creating ECI.
3. The modifications to § 863(b) apply by their terms only to “inventory ... produced (in whole or in part) by the taxpayer.” § 863(b)(2). The existing title passage rules for resellers who are not producers remain unchanged. *See* §§ 861(a)(6) and 862(a)(6). Thus, a taxpayer that buys goods produced by another person within the United States for resale would still be able to claim 100% foreign source income, in addition to potential FDII benefits.

4. The definition of a “producer” under § 863(b) has received less attention from the IRS and the courts in recent years than the definition of “producer” in other areas, such as § 954(d) or § 199. In any event, Treas. Reg. § 1.863-3(c)(1)(i) states that “only production activities conducted directly by the taxpayer are taken into account...” Also, “production assets” include only those tangible and intangible assets that are “owned directly” by the taxpayer and “directly used” by the taxpayer to produce inventory. Treas. Reg. § 1.863-3(c)(1)(i)(B). The intent of this rule was to preclude the consideration of a contract manufacturer’s activities or assets in sourcing income under § 863(b). *See* TD 8687. It would seem to follow the contract manufacturing does not by itself, make one a “producer” for § 863(b) purposes. *See also* FSA 200141010 (addressing whether taxpayer that participated in the Maquiladora program was deemed to be a “producer” for § 863(b) purposes).
5. Consolidated Group Interaction. A taxpayer seeking to mitigate the effects of § 863(b) repeal might consider using a US affiliate to contract manufacture the goods for the US principal company. However, within a consolidated group, the source of income from an intercompany contract manufacturing arrangement is determined as if the Distributor member performed the production activities carried on by its affiliate. *See* Treas. Reg. § 1.1502-13(c)(7)(ii), Example 14. *See also* Section 904(i) & Treas. Reg. § 1.904(i)-1 (addressing certain de-consolidation techniques to change the source of income or § 904 limitation).
6. Partnerships under Treas. Reg. § 1.863-3(g). Generally, production activity and production assets of a partnership are not imputed to a partner, except with respect to sourcing the partner’s distributive share of income allocated from the partnership and on property distributed in kind by the partnership to the partner. *See* Reg. § 1.863-3(g)(2)(i). Thus, if a partnership is a producer of inventory, its income would be sourced under new § 863(b) to the place of production. On the other hand, in the case of partner-partnership transactions, other than distributions or contributions, it would seem that the entity treatment of partnerships under this regulation precludes the non-producing party from being a producer under § 863(b).

E. Future Application of the Look-Through Rules of § 904(d).

1. Under regulations promulgated after the 1986 Act (Reg. § 1.904-5(c)), interest, rents, royalties and dividends paid by a CFC to its parent are generally treated as general basket income, except to the extent characterized as passive basket income on a look-through basis. The Act did not modify § 904(d)(3), the statutory basis for the look-through rules. In fact, Congress left the subpart F look-through rule of § 954(c)(6) in place, which relies on the principles of Reg. § 1.904-5(c) to characterize payments between CFCs for subpart F income purposes.

2. Look-through will not apply to dividends to the US Parent. Such dividends generally will either be subject to tax under § 245A or paid out of Previously Taxed Income generated by subpart F or the GILTI rules.
3. The treatment of interest and related-party royalties under the look-through rules is subject of significant uncertainty. The existing § 1.904-5(c) regulations' matching principle continues to apply unless and until modified by future Regulations. However, there are reasons to expect that new regulations under § 904(d) may be forthcoming and could depart radically from the existing rules:
 - (a) The underlying rationale of the look-through rules is parity between payments by a CFC and income earned directly through a foreign branch. Now, however, income earned through a foreign branch would be allocated to the branch basket rather than the general basket.
 - (b) Related party interest or royalties paid to US parent may reduce the CFC's GILTI or Net Deemed Tangible Income Return (NTDIR). Interest in particular seems likely to reduce the NTDIR under the taxpayer-unfavorable allocation rule § 951A(b)(2)(B). Should a related party royalty allocated against GILTI at the CFC level be treated as general basket income (and potentially FDII) or GILTI for foreign tax credit purposes? Should interest that reduces the CFC's NTDIR be treated as exempt income, GILTI, or general basket income?
4. In reliance on the existing rules, many taxpayers operating in relatively high foreign tax environments have relied on § 904(d)(3) to create general limitation income able to be offset by foreign tax credits. Will such strategies continue to be viable? In light of the reduced rate of tax for GILTI, will such strategies continue to be desirable?

F. What Remains of the General Basket?

1. Prior to 2018, the general basket as a residual category encompassed substantially all of a US group's income. Now, branches are allocated to a separate branch income basket. CFCs' income not captured by Subpart F will in large part constitute GILTI subject to a separate GILTI basket. Section 863(b) as a source of foreign source income has been repealed; in addition, the royalty and interest look-through rules may be subject to regulatory repeal.
2. What remains in the general basket is subpart F income described in § 954(d) and § 954(e), foreign title passage income on non-produced inventory, and other occasional foreign source not derived through a foreign branch. The shrinking of the general basket may have a

significant impact on § 861 expense allocations (see below) and treatment of historic overall foreign sources (OFLs) depending on the manner in which the Treasury undertakes to transition the old baskets to the new baskets.

- G. New Section 960. Section 902 was repealed. Therefore, the old rules of applying an indirect credit on a multi-year basis no longer applies. In its place, Congress enacted a new § 960, with several parts, that applies to “foreign income taxes “properly attributable to” items of income. The intent of this provision is to eliminate the need for computing and tracking cumulative tax pools, an attempt at simplification.⁷ In its place, however, the new § 960 will require tracing of taxes to different “items” of subpart F income, GILTI and distributions of PTI. This may be more complex than the pooling rules.
- H. Section 960(a) – current tax credit for inclusions under § 951(a)(1) – *i.e.*, for Subpart F income.
1. The credit is allowed for the “foreign corporation’s foreign income taxes as are properly attributable to such item of income.”
 2. The credit is allowed to US corporate shareholders is subject to Subpart F. With the repeal of § 902, the 10% voting stock requirement has also been eliminated, so long as the domestic C corporation is a United States shareholder of a CFC. *See also* amended § 951(b) (applying “United States shareholder” test on a vote or value basis).
 3. The term “item of income” is currently defined in the § 954 regulations involving the high-taxed exception of § 954(b)(4). Under those regulations, general basket subpart F income is considered a single item of income, whereas foreign personal holding company income is divided among each of the different subcategories in § 954(c) to determine the “items” of income. *See* Treas. Reg. § 1.954-1(c)(1)(iii). In the case of the old high-taxed kickout of § 904(c), more detailed grouping of items of income is required. *See* Treas. Reg. § 1.904-4(c). How will these definitions of an “item” be applied to new § 960 by the IRS and Treasury in writing regulations?
 4. The conference report directs the IRS to write regulations under § 960 allocating taxes to items of income similar to the rules under Treas. Reg. § 1.904-6(a). This suggests that, once the “items” of income have been identified, the taxes should be attributed to items of income using the same tracing and allocation / apportionment rules that apply under current law.

⁷ Conference Report at p. 392.

5. Indirect Credit on Section 956 Inclusions. Under the final bill, § 956 was retained, so that a CFC with positive “applicable earnings” may have a § 956 inclusion that remains fully taxable under § 951(a)(1)(B). By its terms, § 960(a) would allow an indirect credit for the foreign taxes “properly attributable to such item of income.” However, now that pooling has been repealed, what are the foreign income taxes properly attributable to the § 956 inclusion? Assuming that an indirect credit is available for a § 956 investment, § 956 may allow the taxpayer to affirmatively access high-taxed earnings in lieu of eliminating excess credits with an exempt dividend under § 245A(d). Note that the Act repealed the anti-hopskotch rule of § 960(c), so intervening pools of PTI or low-taxed exempt E&P would no longer be an obstacle to the affirmative use of § 956.
6. Certain “hybrid dividends” are not eligible for the participation exemption under § 245A, and at the CFC level, are treated as subpart F income, notwithstanding any other provision of this title. Section 245A(e). While one would think that hybrid dividends, as taxable income, might carry an indirect credit, the rules disallowing the foreign tax credit in § 245A(d) also apply to hybrid dividends. Thus, hybrid dividends are not a means of avoiding the participation exemption for high-taxed income.

I. Section 960(d) – Foreign Income Taxes with respect to GILTI.

1. Section 960(d) provides a modified indirect credit for “tested foreign income taxes paid or accrued by controlled foreign corporations” of a domestic corporation that has included their tested income in GILTI under § 951A.
2. As with taxes attributable to subpart F income under § 960(a), for GILTI credit purposes, the taxpayer must identify the tested foreign income taxes that are “properly attributable to” to the tested foreign income of a CFC that are taken into account by the US corporate shareholder under § 951A. As noted above regarding § 960(a), in the case of a single CFC with tested income and other income, the allocation of taxes to tested income would seem to rely on the principles of existing Treas. Reg. § 1.904-6.
3. Unlike the basic § 960(a) credit, the indirect credit for tested foreign income taxes is limited to 80% of the aggregate tested foreign taxes multiplied by the domestic corporation’s inclusion percentage with respect to its CFCs. Thus, the GILTI basket involves at least two haircuts to the allowable indirect credit. The inclusion percentage is calculated as the fraction of the domestic corporation’s GILTI over its the aggregate of sums described in § 951A(c)(1)(A) (that is, positive tested income fractions). The apparent intent is to limit indirect credits on GILTI to the fraction of total CFC tested income that is taxed as GILTI, and effectively

allocate a portion of CFC taxes to exempt income, which should be disallowed under § 245A(d).

4. While the disallowance of taxes associated with a distribution of exempt income seems clear, what happens to such taxes if the underlying earnings are subjected to US tax through a § 956 inclusion or a distribution that does not qualify for the participation exemption under § 245A. Do they remain associated with untaxed earnings so that are attributable to an amount included in taxable income under § 956? Is there any authority for claiming an indirect credit for taxes imposed on an actual dividend of live E&P that doesn't qualify for § 245A?
5. The GILTI credit formula may result in somewhat arbitrary application of the foreign tax credit in certain circumstances:
 - (a) The reference to § 951A(c)(1)(A) without a reference to § 951A(c)(1)(B) seems to exclude tested losses of CFC's from the denominator of the fraction, even though such tested losses reduce the US shareholder's GILTI inclusion. Thus, the presence of a CFC with tested loss in the structure may cause taxes imposed on another CFC's positive GILTI to be disallowed.
 - (b) The § 960(d) credit, like the GILTI inclusion itself, seems to be calculated separately for each domestic C corporation in a consolidated group. This creates the possibility for obtaining different foreign tax credit results depending on where different CFCs are located within a single consolidated group.
 - (c) Although the § 960(d) credit is calculated on an aggregate basis across all of the US shareholder's CFCs that contribute to GILTI, tested foreign income taxes are attributed to tested income of the controlled foreign corporation at the CFC level. Therefore, taxes of a CFC that has no tested income (or a tested loss) may not be considered "tested foreign income taxes" that are included in the GILTI credit calculation.

J. Sections 960(b)(1) & (b)(2) – Foreign Taxes attributable to distributions of PTI.

1. The Act substitutes §§ 960(b)(1) and 960(b)(2) for former § 960(a)(3) governing foreign income taxes attributable to distributions of PTI to the US shareholder or to CFCs in a chain of foreign entities. Again, the direct or indirect credit is applied to the taxes "properly attributable to" the portion of earnings that were previously taxed. The Conference Report does not provide any guidance on "proper attribution" of taxes to distributions of previously taxed income ("*PTI*").
2. Existing rules would appear to provide for year by year layering of foreign taxes attributable to PTI distributions. Specifically, Treas. Reg. § 1.959-

3(e) provides for the foreign tax credit to be determined under the LIFO ordering mechanism of Treas. Reg. § 1.959-3(b), whereby a PTI distribution is sourced first to earnings previously taxed under § 956 on a LIFO basis, then to earnings previously taxed under subpart F on a LIFO basis, and finally to live E&P. However, in the case of distributions through a chain of CFCs, the normal ordering rules are changed to give priority to distributions of PTI received from a lower-tier CFC. *See* Treas. Reg. § 1.959-3(e)(1) and 1.959-3(e)(2).

3. Two examples in the current § 959 regulations illustrate the application of this ordering rule. In Example 1, US Corporation A owns CFC R, which owns all of CFC S. During 1963, neither CFC has any Subpart F income, but each of CFC R and CFC S has a taxable § 956 investment of \$100.
4. During 1964, CFC S distributes \$100 to CFC R and CFC R distributes \$100 to the US Parent. In the year of the distribution, CFC R has \$200 of PTI attributable to prior § 956 investments. Under the special ordering rule of Treas. Reg. § 1.959-3(e), the distribution is allocated for foreign tax credit purposes first to the \$100 received from CFC S. Thus, the effect of this rule would seem to be to allow USP to claim as a credit any Country S withholding taxes imposed on the S to R taxes at the earliest possible time.
5. In Treas. Reg. § 1.959-3(e)(2), Example 2, US Corp A owns all of the stock CFC T, which in turn owns all of CFC U. During 1964, CFC T has a taxable investment in US property of \$100. CFC U has no subpart F income or § 956 investments, but pays a dividend of \$100 to CFC T. As a result of CFC T has \$300 of E&P, consisting of operating income of \$200 and a dividend of \$100 received from CFC U. These earnings are classified as \$100 of § 959(c)(1) PTI of CFC T, and \$100 each of operating earnings from CFC U and CFC T. On an actual dividend, however, the distribution is sourced from CFC T's PTI under the normal priority rules of § 959(a). As a result, the special ordering rule giving priority to E&P received from CFC-U does not apply.
6. The § 959 proposed regulations from 2006 further clarify that the foreign income taxes associated with PTI are not treated as part of the post-1986 pools, but rather are “maintained in a separate account and allowed as a credit as provided under § 960(a)(3) when the associated previously taxed earnings and profits are distributed.” Prop. Treas. Reg. § 1.959-3(c).
7. In the proposed regulations' example, USP owns FC which owns FS. During year 1, FS earns 90u of subpart F income and pays 10u of foreign tax. During year 2, FS has no E&P but distributes the 90u to FC. FS's home country imposes a 9u withholding tax on the distribution, so that FC

receives 81u of PTI.⁸ FC also pays tax in its home country of 11u as a result of the receipt of the dividend from FS. As a result FC has PTI attributable to subpart F income of 70u. The Example states that the 30u of foreign income taxes (translated into USD as \$40) are not included in FC's pool of post-1986 taxes, but rather associated with the 70u of PTI and available as a credit "upon distribution of *such* previously taxed earnings and profits."⁹

8. The existing regulations' tracing approach may be adopted for new § 960(b) given the absence of any other applicable rules. Basketing and layering of PTI for purposes of analyzing the creditable withholding taxes will be important. Under Treas. Reg. § 1.904-6(b)(2), taxes imposed on distributions of PTI are allocated among the § 904 baskets using the same principles of this section.
9. The excess limitation account rules of pre-2018 § 960(c) remain in the Code. By their terms, an excess limitation account is only created for distribution of subpart F PTI, and not PTI that is attributable to GILTI. See § 960(c)(1)(A). Query whether the failure to expand § 960(c) to apply to GILTI inclusions may have been unintentional.

K. Treatment of Foreign Withholding Taxes imposed on CFC or DRE Distributions.

1. The allocation of taxes imposed directly on a foreign corporation at the entity level between the different FTC limitation categories (Subpart F, branch, GILTI) seems relatively straightforward. However, the rules present several oddities regarding the allocation of foreign withholding taxes to the different categories in certain situations:
2. As noted above, in § 960(b), the US shareholder is allowed a credit for any taxes not previously claimed as an indirect credit on a distribution of PTI. Assuming the existing § 1.904-6(b) regulations continue unchanged, these taxes are allocated to the basket in which the PTI arose (passive, general, GILTI). For withholding taxes on a distribution of GILTI, should these taxes be subject to the 80% GILTI haircut? Note that foreign withholding taxes associated with a distribution of GILTI would seem to be creditable under § 960(b), rather than § 960(d), and the 80% haircut is applied in § 960(d)(1), not § 960(b).
3. Taxes imposed on a distribution by a DRE of the US Parent to the US parent based on logic should be allocated to the branch basket. However, the § 904(d)(2)(H) base differences rule would seem to support allocating

⁸ See Treas. Reg. § 1.959-3(d).

⁹ Prop. Treas. Reg. § 1.959-3(c)(2), Example (ii) (emphasis added). Although the Example does not illustrate a case with multiple years' or categories of PTI, the reference to "such" PTI in the Proposed Regulations would appear to indicate a tracing approach.

these taxes to the general basket, at least assuming the drafting error noted above is not given effect.

4. Are withholding taxes imposed on a distribution of § 965 PTI subject to partial disallowance under § 965(g)?

L. Continued & Expanded Availability of the High-taxed Exception to Subpart F.

1. Section 954(b)(4) remains in effect as an exception to subpart F income. It also provides an exception to GILTI, to the extent that the income is excluded from foreign base company income by the high-taxed exception. *See* § 951A(c)(2)(A)(i)(II).
2. With the new lower corporate rate of 21%, the high-taxed exception threshold is now 18.9%. More income will constitute high-taxed income than previously. The change to the indirect credit mechanic under § 960 from a multi-year pool to taxes “attributable to” the item of income will change the operation of the high-taxed exception. As noted above, the term “item of income” for this purpose may follow existing Treas. Reg. § 1.954-1, although this depends on regulations.
3. If income is excluded from Subpart F and GILTI under the high-taxed exception, an actual dividend of this income is presumably exempt from tax under § 245A. What if the taxpayer uses § 956 to force an inclusion of E&P from this entity? Could the foreign income taxes properly attributable to the inclusion include the taxes imposed on the earnings over a cumulative period?

M. Pending Litigation involving Section 960(a)(3).

1. Cross motions for summary judgment were recently filed in the case of *Ingersoll Rand Co. v. United States* (W.D. Nc. 3:16-CCV-289) (cross motions filed on Feb. 9, 2018 and March 2, 2018). According to the motions, the case addresses creditability of foreign taxes under Pre-2018 TCJA § 960(a)(3) associated with distributions of previously taxed income created by the 1984 Deficit Reform Act (DRA).
2. Under the DRA, as part of reform of the DISC / Export Trade Income provisions, CFCs which historically had accumulated deferred income were allowed to re-characterize those earnings as previously taxed income in exchange for terminating ETI status. The taxpayer’s CFC elected to terminate ETI status. Its E&P deferred under the ETI rules became PTI. The question in the case is whether a subsequent distribution of the PTI causes the taxes imposed on those earnings to become creditable under § 960(a)(3).
3. The Taxpayer’s motion argues that the plain language of § 960(a)(3) authorizes the credit, and that any mismatch between foreign law and US

law should be resolved by reference to the Section 904 limitation. The taxpayer also cites several cases, including *Helvering v. Campbell*, 139 F.2d 865 (4th Cir. 1944), for the proposition that income taxes imposed on income that is exempt from federal income tax nonetheless are allowable as foreign tax credit. The Government, by contrast, primarily argues based on tax policy that § 960(a)(3) should not be read to provide a “double benefit” of both an exclusion from gross income and credit against US taxes.

4. The ultimate resolution of this case may have bearing, by analogy, on whether foreign income taxes associated with post-1986 undistributed earnings and profits that became PTI under § 965(b)(4) (so-called “deficit PTI”) are creditable under new § 960(b). Similar to Export Trade PTI following the 1984 Tax Reform Act, so-called deficit PTI has been subject to foreign tax and taxes imposed on these earnings may be creditable notwithstanding that the earnings haven’t been directly into account as taxable income.

N. Expense Allocations.

1. In general, allocation and apportionment of expenses under § 861 will be more important for a wide range of taxpayers. The GILTI rules will cause many taxpayers that were previously in a deferral posture to claim indirect credits on an indirect basis. The lower US corporate tax, particularly on GILTI, and mandatory inclusions, will cause more taxpayers to be subject to § 904 limitations. Allocation and apportionment of interest expense, R&D expense, and stewardship / HQ expense will exacerbate this issue, particularly to the extent these expenses are deemed to be allocated and apportioned against GILTI.
2. Section 904(b)(4) provides that, in the case of a specified 10% owned foreign corporation that can pay exempt dividends under § 245A, the US corporate shareholder’s § 904 limitation is calculated without regard to –
 - (a) The foreign source portion of any dividend received from such foreign corporation, and
 - (b) Any deductions allocable or apportionable to “income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such specified 10% owned foreign corporation” or “such stock to the extent income with respect to such stock is other than amounts includible under Section 951(a)(1) or 951A(a).”
3. This rule would seem to imply that expenses are allocated and apportioned against GILTI inclusions under § 951A. On the other hand, this rule seems contrary to § 864(e)(3) which generally provides that tax-exempt income and tax-exempt assets are ignored for purposes of determining an

allocation and apportionment fraction. It also contradicts the clear statement in the Legislative History that the “GILTI indifferent rate” was intended to be 13.125% (*i.e.*, 10.5% / 80% haircut). If expenses are allocated and apportioned to GILTI, a corporate taxpayer with a foreign ETR in excess of 13.125% could end up paying residual US tax on GILTI as a result of allocation and apportionment of deductions and the resulting § 904 limitation.

4. On the other hand, the apportionment rules above seem to exclude from § 904 treatment any expenses allocated and apportioned against the CFC stock to the extent it does not produce subpart F income or GILTI. For example, the holding of CFC stock to produce income exempt from GILTI tax pursuant to the high-taxed exception would seem not to attract an allocation and apportionment of expenses.
5. Repeal of FMV Apportionment. Section 864(e)(2)’s permitting the “fair market value” method of interest expense apportionment is repealed. According to Congress, the election of FMV reporting has “led to inappropriate results and needless complexity.”¹⁰ This repeal, like the repeal of § 863(b)’s 50/50 rule is scored as having minimal budgetary effects.
6. The Senate Bill proposed to accelerate the effective date of worldwide interest expense apportionment under § 864(f). However, this proposal was not included in the TCJA as enacted.
7. R&D expenses. The R&D expense allocation rules of § 1.861-17 will also need to be adapted to the new regime to take into account that the US taxpayer and members of its controlled group may use the IP to produce general basket income, FDII, GILTI or exempt income. If US parent licenses IP to its CFC and generates royalty income, how should the R&D expense be apportioned against the (general basket?) royalty income or GILTI? In the new regime where most CFC income is included on a current basis, taxpayers with US-based R&D expense may find it advantageous to switch from the gross income to the sales method so as to benefit from the enhanced exclusive apportionment of R&D expense based on the location of R&D activity. *See* Treas. Reg. § 1.861-17(c).

O. Basket Reconstruction.

1. In moving from pre-2018 law to the new law, one issue that will arise is characterization of pre-2018 FTC carryovers, pre-2018 overall foreign loss, overall domestic loss, and separate limitation loss accounts, as well as any excess limitation in the 2017 taxable year that might be available for absorb an FTC carryback from 2018.

¹⁰ Conference Report at p. 404.

2. For example, assume that the taxpayer prior to the new regime had a general basket Overall Foreign Loss (“OFL”). In 2018, and later years, the consequences will vary significantly depending on whether the OFL remains a general basket OFL as compared to being converted into a GILTI basket or branch basket OFL.
3. Similarly, taxpayers who have excess foreign tax credits in the general basket that carry forward from 2018 will get significantly different results depending on whether those foreign tax credits remain general basket FTC carryovers under § 904(c) versus being migrated to the branch or GILTI baskets.
4. Writing transition rules to address these situations would seem to be difficult. When the baskets were last modified as part of the American Jobs Creation Act of 2004, Congress provided that taxes carried over from pre-2007 rules would be allocated to the same basket that they would have had if there were only two baskets before 2007. § 904(d)(2)(K). *See also* Treas. Reg. § 1.904-2(i) (providing separate rules for carryovers and carrybacks of foreign tax credits). Similarly, regulations under the OFL and Separate Limitation Loss (“SLL”) rules provided for consolidation of pre-2007 OFLs and SLL into the general basket and passive basket. *See* Treas. Reg. § 1.904(f)-12(h). The Secretary would seem to have a similar task at hand in 2018, except without guidance from Congress in the form of a transition rule. Also, the process of separating baskets would seem to be more controversial than consolidating baskets. Lastly, given the fact that GILTI is not eligible for a carryover under § 904(c), it is not clear how existing general basket carryovers could be characterized as GILTI carryovers.

P. Overall Foreign Loss, Overall Domestic Loss and Separate Limitation Loss.

1. Accelerated ODL Recapture. Section 14304 of the Act allows the taxpayer to elect, for overall domestic losses (ODL) arising in years beginning before January 1, 2018, to recapture up to 100% of the ODL in a subsequent taxable year (as opposed to the normal 50%). This rule can have interactions with the transition dividend under § 965 and the election in § 965(n) to waive NOL carryover deductions for purposes of computing the transition tax liability.
2. Overall foreign loss and separate limitation loss rules remain unchanged; however, the increased number of baskets will make these rules more complex and absence of any GILTI carryover will increase the downside of being in an OFL or SLL position with respect to GILTI. For example, assume that the taxpayer’s CFCs earn \$100 of GILTI with a 10% tax rate, \$0 exempt income and \$100 of foreign base company sales income with a 20% tax rate that is deferred under the high-taxed exception. Assume the taxpayer earns \$400 of US source income. The taxpayer has \$20 each of

interest expense allocated to each of the GILTI and the general basket. Arguably, the single year calculation of the GILTI credit, without carryforwards or carrybacks, makes it inappropriate at a policy level to apply the OFL rules and SLL rules to the GILTI category.

Q. Modifications to Section 905(c).

1. Prior to the tax reform act, § 905(c) provided different treatment of foreign tax refunds, audit assessments and other redeterminations of foreign tax liability at the US shareholder and CFC levels. US shareholder level redeterminations (*i.e.*, of § 901 credits) were subject to a “relation back” approach, whereby the adjustment to the credit was made in the original foreign taxable year. In the case of foreign assessments, this created risk of loss of credits due to expiration of the 10-year statute of limitations under § 6511(d)(3). *See, e.g., Ablemarle Corp v. United States.* At the CFC level, on the other hand, with certain narrow exceptions, § 905(c) redeterminations were made through current year adjustments to the tax pools and E&P pools. *See* Pre-2018 §§ 905(c)(1) (flush language) and 905(c)(2)(B)(ii); Temp Reg. § 1.905-3T(d)(2).
2. The Act, as noted above, repeals § 902 and the multi-year pools of earnings & profits and taxes. To conform to that change, TCJA §§ 14301(c)(20) and 14301(c)(21) strike the sentences referenced above. Under the Act, § 905(c)(2)(B)(i) now provides that subsequent tax payments following an audit “shall be taken into account for the taxable year to which such taxes relate.” This would seem to hearken back to the rules applicable to pre-1987 taxes and pre-1987 accumulated profits, where § 905(c) adjustments were made on an annual layering basis. *See* Temp. Reg. § 1.905-5T; ILM 201444039. Section 14301 is generally effective for taxable years of CFCs beginning after December 31, 2017, years of US shareholders in which or with which such taxable years end. § 14301(d).
3. The change to § 905(c) would apply to taxes paid by CFCs after 2017 that relate back to years prior to 2018. The manner in which this applies, when the prior years were subject to pooling adjustments, but the taxes are required to relate back to those years is unclear and presumably may be a subject of transitional guidance.

IX. PREVIOUSLY TAXED INCOME POST-TRA.

A. § 959 Previously Tax Income and § 986(c) After the Tax Reform Act.

1. Section 959 previously taxed income (“PTI”) was discussed in Section II above in the context of § 965, Prop. Treas. Reg. § 1.986-1(c)-1, and Notices 2018-07 and 2018-13.

2. Inclusions under the § 965 transition-inclusion rules and the GILTI provisions will result in substantial amounts of previously taxed income under § 959 (“PTI”). Distributions of this PTI will result in currency gain or loss under § 986(c). Prop. Treas. Reg. § 1.986(c)-1(b) and (c) and Notice 2018-07, discussed in Section II above, specifically consider the application of § 986(c) to PTI created under the § 965 inclusion rules, including § 965(b) PTI, when those amounts are distributed. It reduces the currency gain or loss amount in the context of § 965. Although seemingly well-intended, the statutory support for this amelioration seems lacking. In any event, the currency gain or loss still could be significant. The currency gain or loss amount also remains undiminished under the GILTI provisions, which are not addressed in the Notice.
3. We thought it would be helpful to discuss some of the rules applicable in the context of § 986(c). The seminal learning starts with Notice 88-71, a 30-year old notice issued shortly after the 1986 Tax Act. The Notice is an “administrative pronouncement” that may be relied on to the same extent as a revenue ruling. Thus, taxpayers can follow the rules in the Notice without concerns about penalties.
4. Eighteen years later, in 2006, Treasury and the IRS issued proposed regulations under § 959. The writers of the proposed regulations, however, seem to have ignored the § 986(c) rules as they were set forth in the 1988 Notice or assumed that taxpayers were not all following the Notice.
5. The proposed § 959 regulations were never finalized. Twelve years have passed since they were issued. Taxpayers, of course, can rely on these regulations or take contrary positions as is the case with all proposed regulations. Treasury and the IRS also could finalize them, although with a prospective effective date since they state they will be prospectively applied when finalized. The proposed regulations state that, after the regulations are adopted, taxpayers will have to conform their accounting for PTI distributions to the rules in the regulations.

B. Notice 88-71.

1. For purposes of determining the amount of foreign currency gain or loss under § 986(c) that must be recognized by a U.S. shareholder with respect to a distribution of PTI, the distribution will not be considered related to a particular tax year. Rather, the amount of § 986(c) currency gain or loss is to be determined using the following formula for each separate § 904(d) category (“basket”) of a shareholder:

$$\begin{array}{rcl}
 \text{Total dollar inclusions} & & \text{Units of functional} \\
 \text{under } \S 951(a)(1) \text{ less} & & \text{currency PTI distributed} \\
 \text{dollar basis of prior PTI} & \times & \frac{\text{Total units of functional}}{\text{currency PTI}} \\
 \text{inclusions} & & \\
 & & \text{Dollar basis} \\
 & & \text{attributed to PTI} \\
 & & \text{distribution} \\
 \\
 \text{Dollar value of PTI} & & \text{Foreign} \\
 \text{distribution} & - & \text{Currency gain} \\
 \text{(Spot Rate)} & & \text{or loss} \\
 & & \text{Dollar basis attributed to} \\
 & & \text{PTI distribution}
 \end{array}$$

2. Thus, to compute foreign currency gain or loss under § 986(c), a shareholder must determine for each of its separate § 904(d) categories the shareholder's functional currency account of PTI and the shareholder's dollar basis in that account. Amounts distributed in any taxable year are removed from the accounts before calculating foreign currency gain or loss in a later taxable year. A distribution of PTI is allocated among the shareholder's PTI accounts in separate categories on an annual LIFO basis with the distribution allocated within each year among the separate categories on a pro rata basis.
3. In an example, a 100%-owned CFC has three years of earnings that generated Subpart F income: 150u, 50u and 200u for 1987, 1988 and 1989 respectively. (The letter "u" refers to the CFC's functional currency.) The exchange rates are \$1:1u for 1987 and 1988, \$.9:1u in 1989, and \$.8:1u in 1990. Thus, the dollar has been strengthening against the relevant foreign currency.
4. The § 986(c) foreign currency gain or loss on a 100u distribution in 1990 is computed with reference to each separate category of the domestic owner's PTI to which the distribution is attributable. In the example, the domestic corporate owner has only general-limitation PTI. Thus, the distribution is attributable only to that PTI account. If more than one account existed, the distribution would need to be allocated to each account.
5. The total dollar basis in each account is computed by adding together the "u" amounts of PTI for each year translated into dollars as provided in § 989(b)(3). This is the same rate used to determine the domestic corporation's Subpart F income inclusion. Thus, the total dollar basis in the domestic corporation's general limitation PTI account before any distribution is made is \$380 ((150u of 1987 PTI x \$1/1u) + (50u of 1988 PTI x \$1/1u) + (200u of 1989 PTI x \$.9/1u)).
6. The dollar value of the PTI distribution is computed by translating the distribution at the spot rate on the date of the distribution as required by § 989(b)(1). Thus, \$80 is received. The § 986(c) foreign currency gain or loss with respect to the 100u distribution of PTI in 1990 is computed as follows:

$$\$380 \quad \times \quad \frac{100u}{400u} \quad = \quad \$95 \text{ dollar basis attributable to PTI distribution}$$

$$\begin{array}{r} \$80 \text{ PTI} \\ \text{distribution} \end{array} \quad - \quad \begin{array}{r} \$95 \text{ dollar} \\ \text{basis} \end{array} \quad = \quad \$15 \text{ (foreign currency loss under } \S 986(c))$$

7. The \$15 loss is a foreign-source general-limitation loss. After the distribution, 100u is removed from the domestic corporation's general basket PTI account and the dollar basis in that account is reduced by \$95 (from \$380 to \$285) for purposes of determining the domestic corporation's § 986(c) foreign currency gain or loss on later distributions.
8. These rules operate separately for § 956 PTI (§ 959(c)(1)) and Subpart F income PTI (§ 959(c)(2)) unless an election is made to combine them. The Notice says regulations will provide how to make the election.
9. The Notice also provides that on a distribution of PTI through a chain of ownership described in § 958(a)(2), the PTI account with respect to the distributee corporation is reduced by the amount of any additional foreign taxes paid on or with respect to the distribution. *See* Treas. Reg. § 1.959-3(d). For purposes of determining foreign currency gain or loss under § 986(c), a shareholder's functional currency account of PTI attributable to a particular upper-tier foreign corporation is reduced by the functional currency amount of those taxes imposed on or with respect to the PTI when distributed through a chain of ownership.
10. In addition, the shareholder's dollar basis in the functional currency account of PTI with respect to the upper-tier will be reduced by the dollar value of the taxes when paid or accrued (taking into account any § 905(c) adjustment). The Notice states that regulations will provide for allocation where there is more than one shareholder to which PTI is attributable.
11. An example in the Notice illustrates the distribution of PTI from lower-tier to upper-tier CFCs. The lower-tier PTI is kept in local currency.
12. In the case of § 1248 transactions, the Notice states that solely for purposes of computing any exchange gain or loss under § 986(c), PTI attributable to stock with respect to which a § 1248 transaction (or § 1291 PFIC transaction) is relevant will be treated as if it were distributed immediately prior to the transaction.
13. The dollar value of the PTI is computed using the spot rate on the date of the transaction as required by § 989(b)(2). Exchange gain or loss will be recognized by the U.S. shareholder. The exchange gain or loss so recognized will increase (or decrease) the U.S. shareholder's adjusted basis in the stock of the foreign corporation for purposes of computing gain or loss with respect to the stock in the transaction. The shareholder's

dollar basis with respect to each account of PTI will be increased (or decreased) by the exchange gain or loss recognized.

14. The Notice contains an example illustrating § 1248 and its interaction with § 986(c).

C. Proposed § 959 Regulations.

1. The proposed regulations under § 959, which as noted above were issued 18 years after the Notice was published, state at Prop. Treas. Reg. § 1.959-3(b)(3)(ii) that for purposes of computing foreign currency gain or loss under § 986(c) and adjustments to stock basis under §§ 961(b) and (c) with respect to distributions of PTI of any foreign corporation, *in lieu of maintaining annual dollar basis accounts* with respect to PTI, a taxpayer may maintain an aggregate dollar basis pool that reflects the dollar basis of all of the corporation's PTI described in §§ 959(c)(1) and 959(c)(2) and treat a pro rata portion of the dollar basis pool as attributable to distributions of that PTI.
2. A taxpayer makes this election by using a dollar-basis pool to compute foreign currency gain or loss under § 986(c) with respect to distributions of PTI or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may be made only with the consent of the IRS.
3. The proposed regulations seem to assume that in the absence of an election, taxpayers must maintain annual dollar basis accounts for purposes of § 986(c). This is contrary to Notice 88-71. For the 18 years between 1988 and 2006, taxpayers presumably were following Notice 88-71's directed methodology, which is a rolling-average methodology. It's unclear why the regulations' draftspersons apparently thought the rule was otherwise or that taxpayers were not following those rules.
4. Possibly, the regulations' draftspersons were concerned that taxpayers with § 986(c) losses might be using a method to accelerate their losses while taxpayers with gains were using a different method to minimize their gains. The election might have been designed to ensure that taxpayers could not switch back and forth.
5. Under the proposed regulation, separate annual dollar-basis accounts also must be maintained for § 959(c)(1) PTI and § 959(c)(2) PTI.
6. While the proposed regulations' annual-dollar-basis approach is different from the rolling-average method provided in Notice 88-71, taxpayers using the Notice's method likely have effectively made the election provided in the proposed regulations in any event. If not, any change would require consent, at least if the proposed regulations were finalized

as they were proposed, although a question would arise as to when the election needs to be made since the regulations by their own terms would be prospective in application.

7. As a result of the new Tax Reform Act we now have three § 904(d) baskets that are potentially relevant: general, passive, and GILTI. The foreign branch category is not likely to have PTI. Thus, applying the rules of Notice 88-71, we have three baskets from which PTI can be distributed: general, passive and GILTI. A LIFO approach apparently will need to be used to determine from which basket the PTI is distributed and then the § 986(c) calculations can be done.

D. Section 864(e)(4).

1. A related PTI issue involves the allocation of interest expense under Treas. Reg. § 1.861-9. Section 864(e)(4) provides that for purposes of allocating and apportioning expenses on the basis of assets, the asset basis of any stock in a non-affiliated 10-percent owned corporation must be (1) increased by the amount of earnings and profits of such corporation attributable to such stock and accumulated during the period the taxpayer held the stock or (2) reduced (but not below zero) by any deficit in earnings and profits of the corporation attributable to that stock for the period.
2. Section 864(e)(4)(D) provides that for purposes of these rules, “proper adjustment” must be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under § 951 or under any other provision of the Code and reflected in the adjusted basis of the stock. Thus, stock basis for these purposes is not increased due to the CFC’s E&P that is PTI. This presumably is to avoid a double counting. This could be a bigger issue now that CFCs will have so much PTI.

E. NYSBA Comments on Previously Taxed Earnings.

1. The NYSBA submitted a report that provides several PTI recommendations. The report also analyzes and compares the results of multiple CFCs conducting foreign activities to the results if the foreign activities were conducted by a single CFC. The report articulates recommendations based on the principle of avoiding double taxation or unintended non-taxation of the same earnings. The report illustrates the need for PTI modifications through a number of helpful examples.
2. The issue of whether and how PTI attributes can be shared within a consolidated group as is very different after the TCJA, and requires consideration of the ability to take FTCs and the complexities of § 1059 (which can operate to reduce basis or create gain if a dividend is

extraordinary and there is no 1-year holding period (or if it is per se an extraordinary dividend under § 1059(e)).

3. The limited gain reduction rule in Notice 2018-7 and the § 965 proposed regulations only applies to distributions of § 965(a) PTI and § 965(b) PTI during the transition year. The NYSBA report recommends that the Treasury should resolve the issue by modifying Treas. Reg. §§ 1.961-1(a)(1) and 1.961-2(a)(1) to clarify that for purposes of determining § 961(b)(2) gain, basis decreases in CFC stock under § 961(b) (and negative basis adjustments pursuant to an election under Prop. Treas. Reg. § 1.965-2(g) (2018)), and gain under § 961(b)(2), do not occur prior to giving effect to basis increases under § 961(a).
4. If Treasury does not clarify that basis decreases, then Treasury should allow distributions during the transition year to be treated as being made first out of § 965(a) PTI and § 965(b) PTI (before other types of PTI), so that such distributions, if necessary, would be eligible for the gain reduction rule.
5. The NYSBA recommends regulations providing that there should be no gain recognition (or basis reduction) by reason of PTI distributions in excess of basis in cases where the upper-tier CFC did not previously increase its basis in lower-tier CFC stock under § 961(a) and (c).
6. Treasury should also issue regulations providing that § 961(c) basis adjustments in lower-tier CFC stock apply not only for purposes of calculating the Subpart F income of upper-tier CFCs, but also for purposes of calculating GILTI tested income of upper-tier CFCs.
7. The NYSBA report states that Treasury should confirm that § 1248 recharacterization is available for § 961(b)(2) gain and should clarify whether § 1248(a)(1) excludes § 965(b) PTI from availability to recharacterize gain as a dividend.
8. Treasury should also consider issuing regulations providing that a § 969(c)(3) deficit is not netted with the amount of PTI; rather, both amounts can coexist as disaggregated components of a CFC's E&P.
9. The NYSBA recommends regulations providing that a distribution under § 301(c)(2) does not reduce PTI; rather, that PTI should only be reduced by the amount of a distribution that otherwise would have been included in gross income by a U.S. shareholder.
10. Treasury should consider if policies, including policies to prioritize the distribution of § 965(a) PTI and § 965(b) PTI, dictate a priority between different types of § 959(c)(2) PTI.

11. The report states that the merits of the proposed PTI account maintenance system and other features of the 2006 proposed § 959 regulations are beyond its scope, and refers the reader to the 2015 NYSBA report on the 2006 proposed § 959 regulations. The scope of the new report generally is limited to issues raised by the TCJA. See for a discussion of computational issue this outline in Section IX above.

X. SECTION 267A.

A. Section 267A provides:

1. No deduction shall be allowed for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.
2. Disqualified Related Party Amount.
 - (a) Disqualified Related Party Amount. The term “disqualified related party amount” means any interest or royalty paid or accrued to a related party to the extent that—
 - i such amount is not included in the income of such related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or
 - ii such related party is allowed a deduction with respect to such amount under the tax law of such country.
 - (b) Related Party. The term “related party” means a related person as defined in § 954(d)(3), except that such section shall be applied with respect to the person making the payment described in paragraph (1) in lieu of the controlled foreign corporation otherwise referred to in such section.
3. Hybrid Transaction. The term “hybrid transaction” means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for purposes of this chapter and which are not so treated for purposes [of] the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.
4. Hybrid Entity. The term “hybrid entity” means any entity which is either—
 - (a) treated as fiscally transparent for U.S. tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or

(b) treated as fiscally transparent for purposes of such tax law but not so treated for U.S. tax purposes.

5. Regulations. The IRS shall issue such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this section, including regulations or other guidance providing for—

(a) rules for treating certain conduit arrangements which involve a hybrid transaction or a hybrid entity as subject to § 267A(a),

(b) rules for the application of this section to branches or domestic entities,

(c) rules for treating certain structured transactions as subject to § 267A(a),

(d) rules for treating a tax preference as an exclusion from income for purposes of applying subsection (b)(1) if such tax preference has the effect of reducing the generally applicable statutory rate by 25 percent or more,

(e) rules for treating the entire amount of interest or royalty paid or accrued to a related party as a disqualified related party amount if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount,

(f) rules for determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country,

(g) exceptions from § 267A(a) with respect to—

i cases in which the disqualified related party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and

ii other cases which the IRS determines do not present a risk of eroding the U.S. tax base, and

(h) requirements for record keeping and information reporting in addition to any requirements imposed by § 6038A.

B. Comments.

1. John Merrick, senior counsel to the IRS associate chief counsel (international), spoke on the hybrid rules at an International Tax Institute

luncheon in New York. The presentation was covered in an article by Lee Sheppard and Alexander Lewis in “News Analysis: IRS May Narrow Scope of Hybrid Rule When Causality Lacking.”

2. Section 267A denies a deduction for any disqualified related party amount paid as part of a hybrid transaction, or by, or to, a hybrid entity.
3. The 267A statutory rules define a hybrid as an entity treated as fiscally transparent under the tax law where it is resident or subject to tax. However, if an entity is transparent or disregarded, it is unclear where it is a resident. Merrick responded that the IRS may refine the scope of residence, and has the regulatory authority to do so. Redefining the scope of residence could be a significant change.
4. According to Merrick, the government will consult the BEPS report but will not be bound by it. The BEPS report, unlike the U.S. rules, generally require a causal connection to exist between the hybrid nature of a transaction and the application of a preferential regime in order to deny a deduction.
5. The U.S. statute does not address double deductions, which were addressed in the BEPS Action 2 report on hybrid mismatches. Merrick explained that double deductions are already addressed by the dual consolidated loss rules.
6. Merrick noted that § 267A is not limited to domestic corporations, or even just corporations. He believes it is clear that § 267A can apply to foreign corporations. Merrick acknowledged that the application of § 267A could result in an increased GILTI tax as a result of payments between CFCs. A denial of the deduction could increase the U.S. parent’s GILTI by increasing the tested income. Merrick said the IRS is aware of the issue and is currently considering whether it should use its grant of regulatory authority to modify that result.
7. Merrick also explained that the IRS is considering how to deal with deductions denied by § 267A in determining E&P.
8. The new hybrid entity rules in § 267A of the TJCA have not received much attention. The hybrid rules are important and more guidance is needed to clarify their scope.

XI. OTHER TAX ACT ISSUES.

A. International Acquisitions and Dispositions After the Tax Reform Act.

1. The new Tax Reform Act’s provisions obviously will have significant effects on negotiating and structuring international acquisitions. We thought we’d discuss some of the new international M&A issues.

2. In considering the sale of stock in a CFC, a U.S. selling shareholder (assume a 100% U.S. corporate shareholder) might have concerns about the buyer's making a § 338 election. Under Treas. Reg. § 1.338-9, a § 338 election causes a deemed sale of the assets of the CFC. Historically, this could increase the CFC's earnings and profits with a resulting increase in the seller's § 1248 inclusion (but with a special sourcing limitation rule set forth in § 338(h)(16)). Subpart F income also could result. Under the new Tax Act's rules, the gain on the deemed-sale of assets will be subject to Subpart F under the GILTI rules and thus taxed directly to the U.S. selling shareholder.
3. The target CFC also will have a lot of previously taxed income ("PTI") as a result of the new rules. The sale will trigger a deemed distribution of the PTI for purpose of § 986(c), as discussed in the section above. Currency gain or loss can result.
4. Historically, the U.S. buyer of a CFC was interested in getting a CFC with a "clean slate" regarding E&P as well as a basis step up in the assets. Following the Tax Act, a U.S. buyer will likely continue to have this interest. If the assets in the target CFC are significant, the basis step-up might help the buyer to avoid substantial amounts of Subpart F income under the GILTI provisions in future years.
5. However, the buyer will have another issue to consider, one that was relevant in the past but which now will take on a significant new role in the buyer's decision whether or not to make a § 338 election. The target CFC will have a lot of PTI under the new rules. The buyer's decision whether or not to make a § 338 election always involved the possibility of using the target company's PTI. Now, the amount of PTI in a given CFC will be substantially higher. The buyer's analysis might involve giving more weight to the benefits of keeping the target CFC's PTI. This, in turn, will involve an analysis of the target CFC's potential built-in § 986(c) gain or loss, which could be zero given the deemed distribution of PTI to the seller for purposes of § 986(c).
6. If a U.S. buyer does not make a § 338 election regarding the acquired CFC, the buyer apparently will have to include the CFC's full-year GILTI amounts in income for the year of sale (similar to the result under § 951(a)). Note §§ 951(a)(2) and 951A(e); *see also* § 951A(e)(2). If a § 338 election is made, both the U.S. buyer and the U.S. seller will have part-year GILTI inclusions.
7. Another consideration on the part of the buyer will be the § 901(m) covered asset acquisition rules. A portion of the foreign taxes paid by the target CFC in future years will be lost as potential foreign tax credits under those rules. However, the value of foreign tax credits likely will be diminished in the future and this ought to become much less of an issue,

especially if all of, or most of, the CFC's income is taxed to its U.S. shareholders under the GILTI rules.

8. The use of debt in acquiring a foreign target company might be less attractive under the new rules. Setting up a structure so that a repatriation of future earnings can be effected in the form of a debt repayment might not be as attractive today. Future earnings will be subject to the GILTI provisions but otherwise can be repatriated free of U.S. tax without the need for debt financing. Debt, however, could minimize foreign withholding taxes. There could be a premium on minimizing future withholding tax.
9. U.S. buyers of a foreign entity that previously had a foreign owner likely will continue to make § 338 elections. In this case, the foreign seller would not be involved with issues under § 1248. Amortizing the increased basis in the target's assets will reduce future GILTI inclusions.
10. The acquisition of a U.S. company will raise new issues as well. Debt-financed structures probably will be less beneficial given the U.S. limitations on deducting interest. However, a foreign buyer in a country with high tax rates and no limitations on local-country interest deductions (like the U.S. used to have) might be inclined to borrow to effect a cash acquisition of the U.S. target. This would give the foreign buyer an advantage over potential competing offers by interested U.S. parties, who will have limitations on how much interest they can deduct.
11. Making a § 338 election in this context will raise interesting issues. Purchasing assets (for example, through § 338) could provide the buyer with a big write off under the new rules for depreciating acquired property. In the context of a domestic § 338 election, however, the target has a deemed one-day tax year in which the U.S. entity is treated as selling its assets. The materially lower U.S. corporate tax rate might make this less painful.
12. In the case of the acquisition of a U.S. company, offshoring intangible property owned by the target could become more difficult with the changes in the § 482 and § 367 rules (including the definition of intangibles).
13. Partnerships will pose special issues given the repeal of *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017), on appeal. The seller of a partnership interest will be subject to U.S. tax to the extent the partnership is engaged in a U.S. trade or business. The buyer of that partnership interest must withhold 10% of the amount realized on the disposition if any of the gain would be treated as effectively connected with a U.S. trade or business.

14. If the buyer fails to withhold, then the partnership must withhold the required amount from any future distributions to the new partner. To avoid withholding, a U.S. seller will need to provide a certification to the buyer that it (the seller) is not a foreign person. Unfortunately, the new rules do not provide for a certification that there is no effectively connected income. Withholding apparently will be required whenever there is a foreign seller of a partnership interest.
15. Partnerships will have a need to know whether a non-foreign person certification was provided, the purchase price and any other information necessary to assess whether it has a withholding obligation.

B. Inbound Financings.

1. An excellent article by Jeff Rubinger and Summer Ayers of Bilzin Sumberg in Miami (2018 TNT 60-9; Tax Notes, March 12, 2018, p. 1511) discusses the myriad of new issues faced by tax advisers in considering inbound financing structures.
2. They discuss §§ 958(b)(4), 267A (hybrid entities and transactions), 163(j) and the portfolio interest rules.
3. The Organization for International Investment has expressed support for Treasury's plan to remove the documentation rules under Treas. Reg. § 1.385-2 and recommended that the § 1.385-3 per se recast rules be removed as well given the new Tax Act provisions. 2018 TNT 55-17.

C. Foreign Tax Credit Carryforwards.

1. The National Association of Manufacturers ("NAM") submitted comments urging that Treasury and the IRS issue transactional guidance regarding the application of the new foreign tax credit regime to foreign tax credit carryforwards available before TCJA that may go to waste because of the new basketing rules under § 904. The comments are discussed in an article by Alexander Lewis dated September 13, 2018. The TCJA divided the general foreign tax credit basket into three baskets: a new general basket, a foreign branch income category basket, and the GILTI basket. The creation of new baskets under § 904 could result in pre-TCJA foreign tax credits in the general basket being stranded in the new general basket, because income that would have been in the prior general basket—and thus creditable under pre-TCJA foreign tax credit carryforwards— could now be allocated to the foreign branch income category basket.
2. NAM urged Treasury and the IRS to avoid adopting rules that would require the mandatory reallocation of pre-TCJA general-limitation foreign tax credits between the new general limitation and foreign branch income baskets. That requirement would be an excessive administrative burden

for manufacturers because it would require retrospective tracing of the source of income at the entity level as opposed to the general calculations done at the controlled foreign corporation level.

3. NAM believes that Treasury and the IRS should issue rules that allow taxpayers to keep their pre-TCJA general limitation carryforwards in the post-TCJA general basket, while also electing to re-allocate pre-TCJA general limitation carryforwards in cases where they can demonstrate a basis for including a carryforward in a different basket.
4. PriceWaterhouseCoopers submitted comments urging Treasury and the IRS to provide a transition rule that will allow U.S. taxpayers to carry forward some excess general category foreign taxes under § 904(c) to the new foreign branch income category in the first year of its existence. 2018 TNT 163-35.
5. The U.S. Chamber of Commerce also raised concerns that existing foreign tax credit carryforwards could be subject to mandatory allocation to new foreign income categories created by TCJA, urging that Treasury issue regulations that include prior foreign tax credit carryforward transition rules and provide a permissive allocation approach. 2018 TNT 170-11.

D. Repeal of § 958(b)(4).

1. Effective for the last taxable year of foreign corporations beginning before January 1, 2018, and each subsequent year, and for the taxable years of United States shareholders in which or with which such taxable years of the foreign corporations and the Tax Act repealed § 958(b)(4). Before repeal, § 958(b)(4) provided that subparagraphs (A), (B), and (C) of § 318(a)(3) were not to be applied to consider a United States person to own stock which is owned by a person who is not a United States person. The subparagraphs of § 318(a)(3) generally attribute stock owned by a person to a partnership, estate, trust, or corporation in which such person has an interest (so-called “downward” attribution).
2. Multiple comments requested guidance be issued addressing the repeal of § 958(b)(4). Treasury and the IRS said that this issue was beyond the scope of the § 965 proposed regulations, discussed in Section II above.
3. However, consistent with § 5.02 of Notice 2018-13, the preamble to the proposed § 965 regulations states that the instructions to Form 5471 will be amended to provide an exception from certain filing requirements for a United States person that is a United States shareholder with respect to a CFC or other specified foreign corporation if no United States shareholder (including the United States person) owns, within the meaning of § 958(a), stock of the CFC or other specified foreign corporation, and the foreign corporation is a CFC or specified foreign corporation solely because a

United States person is considered to own the stock of the CFC or other specified foreign corporation owned by a foreign person under § 318(a)(3).

4. Consistent with § 6 of Notice 2018-13 and § 7 of Notice 2018-26, taxpayers may rely on this exception with respect to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent year of the foreign corporation, and for the taxable years of a United States shareholder in which or with which these taxable years of the foreign corporation end.

XII. SECTION 482, INCLUDING TAX ACT CHANGES.

A. Section 482: Aggregation.

1. The Tax Act added a new third sentence to § 482 that allows aggregation and the consideration of realistic alternatives if it produces the most reliable means of valuation. The exact sentence is:

“For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.”

2. An aggregation rule is also set forth in the temporary § 482 regulations. Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) states that the combined effect of two or more interrelated transactions can be aggregated if aggregation provides the most reliable measure of an arm’s length results under the best method rule.
3. The new third sentence in § 482 and the temporary regulation require valuations on an aggregate basis only when aggregation provides the most reliable measure of an arm’s length result. If there is a reliable comparable transaction and at arm’s length in the marketplace parties do not aggregate, then aggregation is not the most reliable means of valuation. The statute and regulations do not give the IRS unfettered discretion to apply aggregation concepts. The IRS is bound by the arm’s length standard and the best method’s most reliable means of valuation.
4. While the proposed and temporary regulations were issued 2 years ago, the aggregation issue is current due to the “aggregation” codification in the Tax Reform Act.

5. An IRS spokesperson said recently no further changes to the § 482 regulations will be necessary under the Tax Reform Act's § 482 change and that the Tax Act in effect simply provided explicit authority for these regulations.
6. The temporary § 482 regulations were effective September 14, 2015, and applied retroactively to tax years ending on or after that date.
7. The temporary regulations will need to be reissued as final regulations sometime this year, as they have now expired under § 7805(e). They were issued on September 14, 2015. They expired on September 13, 2018.
8. Consistent Valuation of Controlled Transactions.
 - (a) The Preamble stated that the temporary § 482 regulations apply to controlled transactions including controlled transactions that are subject in whole or in part to §§ 367 and 482. Transfers of property subject to § 367 that occur between controlled taxpayers require a consistent and coordinated application of both sections to the controlled transfer of property.
 - (b) The Preamble says that the consistent analysis and valuation of transactions subject to multiple Code and regulatory provisions is required under the best method rule described in Treas. Reg. § 1.482-1(c). A best method analysis under § 482 begins with a consideration of the facts and circumstances related to the functions performed, the resources employed, and the risks assumed in the actual transaction or transactions among the controlled taxpayers, as well as in any uncontrolled transactions used as comparables.
 - (c) For example, states the Preamble, if consideration of the facts and circumstances reveals synergies among interrelated transactions, *an aggregate evaluation under § 482 may provide a more reliable measure of an arm's length result* than a separate valuation of the transactions.
 - (d) The best method rule requires a determination of the arm's-length result in controlled transactions under the method, and particular application of that method, that provides the most reliable measure of an arm's-length result. The Preamble also referred to the "realistic alternative transactions" rule and states that "on a risk-adjusted basis" *this may provide the basis for application of unspecified methods* to determining the most reliable measure of an arm's length result.

9. Compensation Independent of the Form or Character of Controlled Transaction.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A) provides that arm's-length compensation must be consistent with, and must account for all of, the value provided between parties in a controlled transaction, *without regard to the form or character of the transaction*. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties.
- (b) The Preamble says this requirement is consistent with the principles underlying the arm's length standard, which require that arm's length compensation in controlled transactions equal the compensation that would have occurred if a similar transaction had occurred between similarly situated uncontrolled taxpayers.
- (c) The parties' written contracts should not be changed, modified or ignored if they satisfy the economic substance rules of Treas. Reg. §§ 1.482-1(d)(3)(ii)(B) and 1.482-1(d)(3)(iii)(B). *See Claymont Investment v. Commissioner*, T.C. Memo 2005-254 (2005). This new regulation can hardly be reconciled with those two long-standing (20-year) prior regulations, which are still outstanding.
- (d) The Preamble also says that this analysis may provide the basis for the application of unspecified transfer pricing methods to determine the most reliable measure of an arm's length result.

10. Aggregate or Separate Analysis.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) contains what was the entirety of the previous aggregation rule. It was one paragraph in length.
- (b) The temporary regulations changed (the Preamble asserts this was a "clarification") previous Treas. Reg. § 1.482-1(f)(2)(i)(A), which provided that the combined effect of two or more separate transactions (whether before, during, or after the year under review) may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of these transactions provides the most reliable measure of an arm's-length result determined under the best method rule of Treas. Reg. § 1.482-1(c). The new temporary regulations also provides that the *value* provided must be considered.

(c) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) reads in full:

(B) *Aggregation.*—The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm’s length result determined under the best method rule of § 1.482-1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm’s length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is consistent with the value provided, including any synergies among items and services provided.

- (d) The temporary regulation added a new clause to provide that this aggregation principle will also apply for purposes of an analysis under multiple provisions of the Code or regulations. A new sentence elaborates on the aggregation principle by noting that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any *synergies* among items and services provided.
- (e) “Synergies” might have been implicit under the previous final § 482 regulation where appropriate, but under the temporary regulation, it is stated seemingly as a requirement, or at least a requirement to be considered in determining reliability of the result. Under the comparable uncontrolled transaction and other § 482 transfer pricing methods, taxpayers are directed to look to relevant comparable transactions and not simply to determine if synergies are involved.
- (f) The temporary regulation also did not retain the statement in Treas. Reg. § 1.482-1(f)(2)(i)(A) that transactions generally will be aggregated only when they involve “related products or services.” This can present a confusing element in determining when to apply the aggregation rules.
- (g) The temporary regulations also state that an analysis may be appropriate to determine if the overall compensation is consistent

with the *value* provided. However, “value” may be – likely is – different from a comparable uncontrolled price. Thus, the temporary regulation muddied the waters by interposing “value” into the general § 482 transfer pricing rules.

- (h) Transfer pricing is transactional and CUTs are the gold standard. The price charged for the sales of goods and a royalty need a “value” analysis if both are supported by valid CUTs do not. Comparables are the backbone of transfer pricing. Comparables are the heart of the arm’s length standard.

11. Aggregation and Allocation for Purposes of Coordinated Analysis.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) provides that, for one or more controlled transactions that are governed by one or more provisions of the Code and regulations, a coordinated best method analysis and evaluation of the transactions may be necessary to ensure that the *overall value provided* (including any synergies) is properly taken into account.

12. Allocation of Portions of an Adjustment.

- (a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(D) provides that *in some cases it may be necessary* to allocate portions of the arm’s length result that was properly determined under a coordinated best method analysis among the interrelated transactions. An allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result for each allocated amount.
- (b) It is odd that this rule applies only “in some cases.” This regulation creates uncertainty in its application.

13. Recent Tax Court Decisions Regarding Aggregation.

- (a) The Tax Court recently addressed IRS aggregation arguments in *Medtronic v. Commissioner*, T.C. Memo. 2016-112 (2016), remanded on another issue, ___ F.3d ___ (8th Cir. 2018), *Guidant v. Commissioner*, 146 T.C. No. 5 (2016), *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (2017), on appeal, and *Veritas Software Corp. v. Commissioner*, 133 T.C. No. 297 (2009). These cases all involved § 482 aggregation regulations as they existed before the new statutory language and the temporary regulations.
- (b) Under the IRS’s view, aggregation was required in all of these cases. The Tax Court held that transactions may be aggregated if an aggregated approach produced the “most reliable means of

determining the arm's length consideration for the controlled transactions.” If the transactions were accounted for and priced separately in the marketplace then aggregation is not the most reliable means of valuation.

- (c) Whether the IRS abused its discretion by aggregating transactions is a question of fact. In *Medtronic*, *Guidant*, *Veritas* and *Amazon*, aggregating the transactions did not result in a reasonable determination of true taxable income.
- (d) The Tax Court has repeatedly rejected the IRS's attempt to aggregate transactions based on the fact that aggregation does not produce a reliable result. If there is a reliable CUT transaction then aggregation is not appropriate if aggregation is not done in the marketplace.
- (e) The new third sentence in § 482 and the temporary § 482 regulations retain the “most reliable means” standard and the arm's length standard should be read consistently with the Tax Court's aggregation holding in *Veritas*, *Amazon* and *Medtronic*.
- (f) Medtronic successfully argued in Tax Court that the transactions should not be aggregated and that aggregation would treat the foreign manufacturing subsidiary more like a contract manufacturer, failing to take into account its full role. The court held that the functions at issue can exist independently and that the regulations did not require that the transactions be aggregated. The Tax Court held that transactions may be aggregated under the regulations only if an aggregated approach produces the “most reliable means of determining the arm's length consideration for the controlled transactions.” The court held the covered transactions are accounted for and priced separately in the marketplace and should not be aggregated. The Tax Court's holding in *Medtronic* is consistent with the new third sentence in § 482 and the temporary § 482 regulations requiring aggregation when it is the most reliable means of valuation.
- (g) In *Veritas*, the IRS argued an aggregation “akin to sale” theory for valuing cost shared intangibles. The Service argued the transfer of existing intangibles was akin to a sale of the business to the Irish subsidiary. The Service asserted that because the assets collectively possessed synergies that imbue the whole with greater value than each asset standing alone, it is appropriate to apply the “akin to a sale” theory and aggregate the controlled transactions, rather than value each asset. The Tax Court rejected the Service's aggregation and the “akin to sale” income method stating it was not the best or most reliable method for valuing the intangibles.

The Tax Court’s holding in *Veritas* is consistent with the new third sentence in § 482 and the temporary § 482 regulations.

- (h) In *Amazon.com*, the Tax Court rejected the IRS’s attempt to relitigate the same cost-sharing transfer pricing issues the IRS lost on in *Veritas*. The IRS claimed that the transferred property had to be valued as integrated components of an operating business, in effect, treating the transfer of preexisting intangibles as economically equivalent to the sale of an entire business. The Tax Court held that aggregation did not yield a reasonable means — much less the most reliable means — of determining an arm’s-length buy-in payment because it improperly aggregates preexisting intangibles and subsequently developed intangibles. The Tax Court’s holding in *Amazon* is consistent with reliability standard in the new third sentence in § 482 and the temporary § 482 regulations.

B. Section 936(h)(3)(B).

1. The Tax Act added goodwill, going concern value and workforce-in-place, and any other item of value or potential value which is not attributable to tangible property or the services of any individual to the definition of intangibles in § 936(h)(3)(B). Specifically, Congress added:
 - “(vi) any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment); or
 - “(vii) any other item the value or potential value of which is not attributable to tangible property or the services of any individual.”
2. The language in (vii) replaced the previous flush language which stated “which has substantial value independent of the services of any individual.” Also, old (vi), which was deleted, said simply “any similar item.”
3. Section 936(h) was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 213(a)(2), and was intended to curb the perceived abuse that taxpayers would transfer intangible property that had been developed in the U.S. to a possession corporation in order to claim a credit under § 936. Other sections of the Code that refer to the definition of intangible property in § 936(h)(3)(B) have similar intended purposes. In this regard, it is notable that the definition of intangible property under § 936(h)(3)(B) largely was taken from the old § 482 regulations relating to the transfer or use of intangible property; thus, the intent seemed to be to cover items that could be licensed or sold in the marketplace to unrelated purchasers.

4. The change in the definition of intangible in § 936 would seem not to impact the cost sharing regulations in § 1.482-7 which has its own definition of intangible property and platform contributions. Under the cost sharing regulations, a cost shared intangible is any intangible, within the meaning of § 1.482-4(b). Treas. Reg. § 1.482-7(j). Under § 1.482-4(b) an intangible is an asset that is one of the listed assets (patent, copyrights, trademarks, etc.) and other similar items if they have value independent of the services of an individual. A platform contribution, however, is stated to include “any resource, capability, or right ... that is reasonably anticipated to contribute to developing cost shared intangibles.”
5. The Tax Act change does not change what cost-sharing anticipated benefits are (defined in the regulations as increased income and decreased expenses) and does not change what costs are R&D costs that must be shared.
6. The inclusion of these items in the statutory definition could affect the way the IRS argues cost-sharing buy-in cases in the future, however. *See Amazon, infra*, at E.5. (d) and (e). This assumes, of course, that corporations’ commence buy-ins after the statutory change’s effective date. However, these items are still items that, as the Tax Court stated, “cannot be bought and sold independently” and they still are “an inseparable component of an enterprise’s residual business value.” They also “do not derive their value from their intellectual content or other intangible properties.” The IRS nonetheless asserts in its appeal that the statutory changes somehow help its case (*i.e.*, a “bootstrap” argument).
7. While § 367(d) references § 936(h)(3)(B), the § 367 regulations that were finalized last year already added goodwill and going concern. The revised § 367 regulations required taxpayers to elect § 367(d) for foreign goodwill and going concern to avoid being taxed on the fair market value of the assets in the year of the transfer. Section 367 itself, of course, was materially changed, as discussed in Section I (above) at p. 4. As a result, the treatment under § 367(d) is no longer elective or optional.

C. Altera.¹¹

1. The Ninth Circuit, initially at least, reversed the Tax Court’s unanimous “reviewed by the court” decision in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), and held in a 2-1 decision that Treas. Reg. § 1.482-7(d)(2) requiring related entities to share the cost of employee stock compensation (the “2003 Regulation”) was a valid regulation. The decision, and moreso

¹¹ For purposes of full disclosure, we (Fenwick) were counsel in *Xilinx*. This also gives us what we hope is a helpful perspective regarding both *Xilinx* and *Altera*. In addition, thanks to our Fenwick tax partners, Kenneth Clark and Ron Schrotenboer for their helpful comments.

the Court's opinion itself, came as major surprises. Moreover, as discussed below, there have been some additional surprising developments in the case since the Court's initial decision was published.

2. The Ninth Circuit, in holding for the IRS, would have permitted the IRS to take the United States off the § 482 arm's length standard, which has long been the transfer pricing standard in the U.S. and most foreign countries. In an odd twist, while the IRS argued for this result in *Altera*, the U.S. government, in fact, was rigorously defending the arm's length standard in the recent BEPS proceedings. The arm's length standard is also contained in all of our tax treaties, including some that await Senate approval.
3. The Court's opinion was written by Chief Judge Thomas. A strong dissent was written by Judge O'Malley. The other judge in the majority, Judge Reinhardt, passed away four months before the case was officially decided and the opinions filed. A footnote stated that he fully participated in the case and formally concurred in the majority opinion prior to his death. However, this timing raises some questions, including whether in fact he had read the final opinion or even even saw the dissenting opinion, and whether he formally concurred with the majority opinion, which was not published until four months after his death.
4. In a surprising post decisional development, Judge Graber was appointed to the Ninth Circuit's three judge *Altera* panel to replace deceased Judge Reinhardt. The Court's decision had already been published and its opinion filed, although only two weeks earlier. Judge Graber presumably was appointed to the panel in case there was need for a re-hearing. The second surprising post decisional development came a week later: the Court announced that its opinion was being withdrawn "to allow time for the reconstituted panel to confer on this appeal." Perhaps this second post-decisional development was less surprising, given the reaction of the tax community and the apparent conflict with the Court's earlier decision in *Xilinx*. Re-argument in the case took place on October 16, 2018.
5. History of the Issue.
 - (a) *Altera* was a follow-on to *Xilinx v. Commissioner*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010). In *Xilinx*, the Tax Court held that under the § 482 cost-sharing regulations then in force (1996), controlled entities entering into qualifying cost-sharing arrangements ("QCSAs") need not share stock-based compensation costs because parties operating at arm's length would not do so. The Ninth Circuit affirmed. In an effort to overrule what the IRS apparently feared would be the result in *Xilinx* (or to try to sway the *Xilinx* court), Treasury and the IRS proposed changes to the § 482 regulations two months after *Xilinx* filed for partial summary judgment.

- (b) That regulation, when finalized, the 2003 Regulation, required controlled parties that enter into QCSAs to share stock-based compensation regardless of evidence that parties do not do so at arm's length. The Tax Court in *Altera* held the regulation invalid in a unanimous "reviewed by the court" decision.
- (c) The § 482 regulations have long provided provide that in determining the true taxable income of a controlled taxpayer, "the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." This guiding principle has been stated in the § 482 regulations for decades and is still there. The arm's length standard is also incorporated into all income tax treaties between the United States and foreign countries. Decades ago, the US in fact urged the adoption of this standard by many foreign countries in their national tax systems.
- (d) In issuing the 2003 Regulation, Treasury and the IRS first published a proposed version of the regulation, a notice of proposed rule-making and a notice of public hearing. A number of persons testified at the hearing and many written comments were submitted.
- (e) Some commenters said that they knew of no transactions between unrelated parties, including any cost-sharing arrangements, service agreement, or other contracts, that required one party to pay or reimburse the other for amounts attributable to stock-based compensation. Some comments were based on surveys of association members. Some commenters represented that they had conducted multiple searches of electronic data gathering and found no cost-sharing agreements between unrelated parties in which the parties agreed to share either the exercise spread or grant value of stock-based compensation.
- (f) Several commenters identified and submitted arm's length agreements in which stock-based compensation was not shared or reimbursed. Some cited the practice of the federal government, which regularly enters into cost-sharing and cost-plus-a-fee contracts at arm's length. They noted that federal acquisition regulations prohibit reimbursement of amounts attributed to stock-based compensation.
- (g) One of our Fenwick tax partners, Ron Schrottenboer, testified at the hearing. He spoke about Fenwick's experience in litigating the *Xilinx* case and our research and evidence, which was later produced at the *Xilinx* trial regarding whether parties dealing at arm's length share stock-based compensation.

- (h) Nevertheless and notwithstanding this substantial body of evidence regarding arm's length dealings and apparently without considering any economic studies or data, Treasury and the IRS issued the regulation as final anyway. The final rule explicitly required parties to QCSAs to share stock-based compensation costs. Treasury and the IRS also added sections to Treas. Reg. §§ 1.482-1(b)(2)(i) through 1.482-7(a)(3) to provide that a QCSA can produce an arm's length result only if parties' costs are determined in accordance with the final regulation.
- (i) In addressing Altera's challenge to the regulation's validity, the Tax Court considered the application of principles of administrative law, including in particular, the Administrative Procedure Act ("APA"). Under § 553 of the APA, in promulgating regulations through informal rulemaking, an agency must: (1) publish a notice of proposed rulemaking in the Federal Register; (2) provide interested parties an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without the opportunity for oral presentation; and (3) after consideration of the relevant matter presented, incorporate in the rules adopted a concise general statement of their basis and purpose.
- (j) Under APA § 706(2)(A), a court must hold unlawful and set aside agency action, findings and conclusions that it finds them to be arbitrary, capricious, and an abuse of discretion or otherwise not in accord with the law. A reviewing court must ensure that the agency "engaged in reasoned decision-making." Under *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Aut. Ins. Co.*, 463 U.S. 29 (1983) ("*State Farm*"), normally an agency rule would be arbitrary and capricious if the agency relied on factors that Congress had not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.
- (k) The Tax Court then said the standard to be applied in every case under § 482 is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer, citing *First Sec. Bank of Utah v. Commissioner*, 405 U.S. 394 (1972) (quoting Treas. Reg. § 1.482-1(b)(i)) ("*First Sec. Bank of Utah*"); accord, Treas. Reg. §§ 1.482-1(a)(i) and (b)(i), and Treasury Department technical explanations of several treaties.
- (l) The IRS contended that Treasury should be permitted to issue regulations modifying—or even abandoning—the arm's length

standard. 145 T.C. at 118. The Tax Court stated that Treasury’s preamble to the final rule did not justify the 2003 Regulation on the basis of any modification or abandonment of the arm’s length standard, and stated that the IRS conceded that the purpose of § 482 is to achieve tax parity in related party transactions with unrelated party transactions. *Id.*

- (m) The preamble to the 2003 Regulation also did not dismiss any of the evidence submitted by the commenters regarding unrelated party conduct as addressing an irrelevant or inconsequential factor. The Tax Court stated that it did not decide whether Treasury would be free to modify or abandon the arm’s length standard because it had not done so. 145 T.C. at 119.
- (n) In holding that the 2003 Regulation was invalid, the Tax Court closed with the statement that Treasury’s “*ipse dixit* conclusion, coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decision-making.” 145 T.C. at 134, quoting *Ill. Pub. Telecomms. Ass’n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997).
- (o) All of the Tax Court judges participating in the case agreed with the Court’s opinion. There were no dissenting opinions. The decision was unanimous.
- (p) The term “*ipse dixit*” refers to an unsupported statement that rests solely on the authority of the individual who made it. It describes a dogmatic statement that the speaker expects the listener to accept as valid. A particular US government official was quoted as saying in 2008 that “we [the U.S. government] can simply interpret arm’s length to mean what we think it should mean, and if we say it correctly, that is what it means.” The IRS’ 2003 Regulation says the sharing of stock-option compensation in a QCSA context is arm’s length conduct. This is an *ipse dixit* statement.

6. Xilinx in the Ninth Circuit.

- (a) As more fully discussed in the amicus curiae brief that was written by Larissa and Fenwick tax partners Kenneth Clark and Ron Schrotenboer on behalf of Xilinx and that was filed with and accepted by the Ninth Circuit in *Altera, Xilinx* started out as a case that the IRS had “designated for litigation.” Under the IRS’s standards, this means that *Xilinx* would be litigated to “establish judicial precedent” and to “conserve resources.” This by no means is a small and irrelevant point. The matter was decided and judicial precedent was established. Nonetheless, it didn’t stop there.

- (b) The IRS’s arguments for the validity of the 2003 Regulation presented to the Ninth Circuit in *Altera*, including those based on the 1986 addition of the CWI sentence in § 482, are the same as the arguments the IRS made in *Xilinx* - and which both the Tax Court and the Ninth Circuit rejected.
- (c) In *Xilinx*, all three judges agreed that including stock options did not generate an arm’s length result.¹² The majority opinion in the Ninth Circuit’s first *Xilinx* decision states that “... the all costs requirement is irreconcilable with the arm’s length standard ...” and the dissent states “The Commissioner of Internal Revenue has issued regulations that are irreconcilable.” 567 F.3d 482 (9th Cir. 2009).
- (d) Nevertheless, the two Ninth Circuit judges in the majority initially determined that the IRS had the authority to issue, and did issue, a regulation under § 482 that required an adjustment that was not arm’s length. Throughout that litigation the IRS had never claimed that it had that authority. Thus, the initial Ninth Circuit opinion adopted a position that the IRS had never asserted.
- (e) Xilinx requested reconsideration of that Ninth Circuit opinion. In the IRS’s reply to Xilinx’s motion, the IRS supported the Ninth Circuit’s conclusion, but said it did not agree with the reasoning. That is, the IRS did not support the conclusion that it had authority to issue, and that it had issued, a regulation that generated a non-arm’s length result.
- (f) The Ninth Circuit withdrew its first opinion and issued one that upheld the Tax Court’s decision. 598 F.3d 1191 (9th Cir. 2010). The second opinion stated:

“Purpose. Purpose is paramount. The purpose of the [§ 482] regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm’s length is trumped by 7(d)(1) [of the regulations], the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.”

¹² This would seem to be the biggest single issue in *Altera*. The Service argues in *Altera* that the regulation is arm’s length yet in the Ninth Circuit’s *Xilinx* case, all three judges agreed that the result the IRS sought there was not arm’s-length. In *Xilinx*, this initially led to a holding that the IRS had the authority to write a regulation that produced a non-arm’s length result. The IRS did not agree with that reasoning, and ultimately lost the case.

598 F.3d at 1196. The Ninth Circuit held that the arm's length standard is the purpose of the § 482 statute and that a regulation cannot be construed to override the arm's length result.

- (g) All of the judges in *Xilinx* also agreed that Treas. Reg. § 1.482-7(d) required stock options to be cost shared (although the Tax Court had not decided that issue but rather assumed it for purposes of its analysis). On reconsideration, the Ninth Circuit's second opinion determined that the requirement of arm's length in every case took precedence over a requirement in the cost sharing regulation to include stock options because of the purpose of § 482 to achieve parity.
- (h) Thus, because the Ninth Circuit panel in *Xilinx* agreed that the previous regulation already required stock options to be cost-shared, the only real change in the 2003 Regulation from the earlier regulation litigated in *Xilinx* is the IRS's *ipse dixit* statement to the effect that "it is arm's length if you do what I say; it's not arm's length if you don't and you may not present any evidence to show our result is not arm's length."
- (i) Further, in *Xilinx*, all three Ninth Circuit judges determined that the IRS's arguments based on CWI, the 1986 legislative history, and the assertion that sharing costs reasonably reflects the actual economic activity, did *not* produce an arm's length answer. Judge Reinhardt, in particular, said that the IRS "[Commissioner's] preference is that we find somehow that the arm's length standard is met by way of the all costs requirement. I must confess that I have difficulty following his reasoning and ... am not persuaded by that argument." 598 F.3d at 1200 n.2.

7. Altera in the Ninth Circuit: The Government's Arguments.

- (a) One might have expected that the Ninth Circuit would have had an easy time affirming the Tax Court's decision. Not only was the Tax Court's unanimous opinion compelling under the APA, but also the Ninth Circuit itself already had affirmed the Tax Court in *Xilinx* regarding QCSAs, the arm's-length standard, and stock-option compensation.
- (b) However, when we read the government's briefs and especially when we listened to the oral argument, we felt a mild sense of concern. As it did in *Xilinx*, the government contended that Altera's stock-based compensation cost should be shared as any other cost based on the CWI approach, regardless of whether unrelated parties in the same circumstances would agree to share such a cost. This seemed to be an effort to abandon the arm's

length standard. The government's CWI arguments in this respect seemed even stronger on oral argument.

- (c) The government also argued that CWI should apply well beyond its statutory limits. The government argued that CWI applied even where there was no "transfer (or license) of intangible property." Under the government's view, CWI would also apply to the *development* of intangible property. This issue was discussed during the oral argument. The Service said nothing *precludes* it from doing this. However, this is not what the statute authorizes regarding CWI.
- (d) At the oral argument, available at https://www.ca9.uscourts.gov/media/view_video.php?pk_vid=0000012327, while the IRS said that it could not do away with the arm's length standard, it also argued that in this area you don't look to what unrelated parties do. You look to CWI. You don't need to do a comparability analysis. According to the IRS, Congress enacted a presumption: if alleged comparables don't satisfy CWI, the transaction is not a comparable. CWI is a check. You must look to actual profit. You can't override the CWI analysis with evidence of third party comparables. CWI means you look to internal standards.
- (e) Our concern was, what if the government was successful in the Ninth Circuit? In that case, the CWI concept would be broadened enormously in a manner that likely would fail to satisfy even Treasury and the IRS. They already were unhappy with both Ninth Circuit opinions in *Xilinx*.
- (f) The CWI rules are set forth in Treas. Reg. § 1.482-4 as a simple periodic-adjustment provision. Treasury and the IRS have long believed that the CWI provision is in accord with the arm's length standard. Treas. Reg. § 1.482-4 specifically requires that any CWI periodic adjustments must be arm's length: "Adjustments made pursuant to this paragraph (f)(2) [CWI] shall be consistent with the arm's length standard and consistent with the provisions of § 1.482-1." Treas. Reg. § 1.482-4(f)(2)(i). Treasury and the IRS also have so stated many times (for example, in the 1988 White Paper (Notice 88-123), at least one IRS Chief Counsel Memorandum,¹³ and treaty negotiations and treaty technical explanations). The Government's arguments, if successful in *Altera*, would broaden CWI far beyond all recognition, and well beyond the arm's length standard.

¹³ That the "CWI standard must be applied consistently with the arm's length standard" is discussed at length in the IRS's Office of Chief Counsel's Memorandum dated March 23, 2007 (AM-2007-007). In fact, that is the title of the first section under the "Law and Analysis" part of the Chief Counsel Memorandum.

- (g) We were disappointed that the Government would try to use CWI to achieve its ends, that is, to argue for such a major change in the tax law – taking the U.S. off the arm’s length standard even if only in part – simply to defend this single regulation. This is not what CWI is all about. The Service tried to do so before (in *Xilinx*), but was making the argument more forcefully this time and in fact, as the Tax Court noted, even argued that the IRS could write a regulation abandoning the arm’s length standard.
- (h) The Treas. Reg. § 1.482-4 regulations, which as noted are the CWI regulations, implement CWI via a simple periodic-adjustment provision regarding the transfer or license of intangibles. Treas. Reg. § 1.482-4 is entitled “Methods to Determine Taxable Income in Connection with a Transfer of Intangible Property.”
- (i) Under Treas. Reg. § 1.482-4, the comparable uncontrolled transaction method evaluates whether the amount charged for the controlled transfer of intangible property is arm’s length by reference to the amount charged in a comparable controlled transaction. The regulation also provides that if the intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. That is, each year the amount received for the license or sale of the intangible must be examined, in effect, to make sure that that year’s income amount is arm’s length as judged by that year’s income that the intangible produced.
- (j) There are no magical unknown boundaries regarding what “CWI” means. The concept is pretty simple. It also deals only with the transfer of intangible property by sale or license, and requires a re-examination of the amount received each year in a long-term license or sale of the intangible property.¹⁴ It does not apply to agreements to *develop* intangibles, or how to allocate current-year costs in determining the current-year’s income.

8. The Ninth Circuit’s Consideration of the APA.

- (a) While the Court’s now-withdrawn *Altera* opinion obviously was the majority opinion, we think it easier to understand the majority opinion by discussing Judge O’Malley’s dissenting opinion first. Her dissent is lengthy (17 pages).

¹⁴ Certain exceptions apply, for example, if the increased profits are due to unforeseen circumstances beyond the control of the taxpayer. Treas. Reg. § 1.482-4(f)(2)(ii)(D).

- (b) Judge O'Malley stated that a "foundational principle of administrative law [is] that a court may uphold agency action only on the grounds that the agency invoked when it took the action." Her dissenting opinion further states that in promulgating the 2003 Regulation, "Treasury repeatedly insisted that it was applying the traditional arm's length standard and that the resulting rule was consistent with that standard. Today, however, the majority holds that Treasury's citation to the legislative history surrounding the enactment of the Tax Reform Act of 1986 'communicated its understanding that Congress had called upon it to move away from the historical arm's length standard.'"
- (c) The majority found that, "despite Treasury's own statements to the contrary, that same citation to legislative history sufficed to 'make it clear enough' to interested parties that Treasury was changing its longstanding practice of applying the arm's length standard in all but the narrowest of circumstances."
- (d) The majority, in effect, "suppl[ies] a reasoned basis for the agency's action that the agency itself had not given. ... It also endorses a practice of requiring interested parties to engage in a scavenger hunt to understand an agency's rule-making proposals. That is inconsistent with another fundamental [APA] principle: that a notice of proposed rule-making should be sufficiently descriptive of the 'subjects and issues involved' so that interested parties may offer informed criticism and comments."
- (e) Judge O'Malley states that she "would find, as the Tax Court did, that Treasury's explanation of its rule did not satisfy the *State Farm* standard; that Treasury did not provide adequate notice of its intent to change its long-standing practice of employing the arm's-length standard; and that its new rule is invalid as arbitrary and capricious... [She] would also hold that [the Ninth Circuit's] previous decision in *Xilinx v. Commissioner*, [citation omitted] controls and mandates an order affirming the Tax Court's decision."
- (f) Judge O'Malley's dissenting opinion states that the purpose of § 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer, citing *First Sec. Bank of Utah*, 405 U.S. 394, 400 (1992) (quoting Treas. Reg. § 1.482-1(b)(1)(1971)). The "touchstone" of this tax parity inquiry is the arm's-length standard. *Xilinx*, 598 F.3d at 1198 n.1 (Fisher, J., concurring). "Since the 1930s, Treasury regulations consistently have explained that 'in determining the true taxable

income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.”

- (g) The 1986 amendment that introduced the CWI standard “did not dislodge the arm's length test. ... Treasury reiterated in its 1988 ‘White Paper’ that ‘intangible income must be allocated on the basis of comparable uncontrolled transactions if comparables exist. ... Indeed, the United States continued to insist in tax treaties, and documents that Treasury issued to explain these treaties, that § 482 reflected the arm's length principle.” See *Xilinx* 598 F.3d at 1196-97.¹⁵
- (h) “When Xilinx challenged the IRS's interpretation, the Tax Court decided the agency's reading violated Treas. Reg. § 1.482-1 because the IRS had not adduced evidence sufficient to show that unrelated parties transacting at arm's length would share expenses related to stock-based compensation. [citation omitted] The Commissioner did not appeal this underlying factual finding and, instead, argued on appeal to the Ninth Circuit that Treas. Reg. § 1.482-7 superseded the arm's length requirement of Treas. Reg. § 1.482-1.”
- (i) “All three members of the divided [Ninth Circuit *Xilinx*] panel therefore assumed that sharing expenses related to stock-based compensation would be inconsistent with the arm's length standard. ... [The panel] also assumed that Treas. Reg. § 1.482-7 required stock-based compensation expenses to be shared.”
- (j) “But a majority of the [*Xilinx*] panel ultimately held that the arm's length standard, which was the fundamental ‘purpose’ of the regulations, trumped Treas. Reg. § 1.482-7, and therefore that stock-based compensation expenses could not be shared in the absence of evidence that unrelated parties would share such costs.”
- (k) “The Tax Court considered and rejected Treasury's stated explanation for [the 2003 Regulations] — that Treasury applied the [CWI] test because it could find no transactions comparable to the QCSAs at issue, and that Treasury's analysis was actually consistent with the arm's-length standard. But the Commissioner now argues on appeal, and the majority accepts, that what Treasury was *actually* saying is that § 482 no longer requires an arm's-length analysis.” Judge O'Malley disagreed.

¹⁵ The majority observed that more recent Tax Treasury explanations have also cited the “alternative” CWI standard. As the dissent points out, “Even these explanations, however, emphasize the primacy of the arm's length standard, and they assure the reader that the [CWI] standard operates ‘consistently with the arm's length standard.’ Technical Explanation of the U.S.-Poland Tax Treaty, at pp. 30-31 (Feb. 13, 2013).”

- (l) In Treasury’s notice of proposed rule-making, it explained the origins of the CWI standard and discussed the 1988 White Paper. Treasury noted, in particular, the White Paper’s observation “that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm’s length standard.”
- (m) “Treasury expanded on its reasoning in the preamble to the final rule. It explained that the tax treatment of stock-based compensation in QCSAs would have to be consistent ‘with the arm’s length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines).’” Treasury observed, however, that the legislative history of the 1986 amendment to § 482 “expressed Congress’s intent to respect cost-sharing agreements as consistent with the commensurate with income standard, and therefore consistent with the arm’s length standard if and to the extent that participants’ shares of income ‘reasonably reflect the actual economic activity undertaken by each.’”
- (n) “Applying this standard, Treasury declared that ‘in order for a QCSA to reach an arm’s length result consistent with legislative intent,’ the QCSA must include stock based compensation among the costs shared.”
- (o) “Throughout the preamble, Treasury repeatedly emphasized that it was applying the arm’s length standard. Treasury explained, for example, that ‘[t]he regulations relating to QCSAs *have as their focus* reaching results consistent with what parties at arm’s length generally would do if they entered into cost sharing agreements for the development of high profit intangibles.’”
- (p) Judge O’Malley said “the Commissioner does not meaningfully dispute the Tax Court’s determination that Treasury’s analysis under the arm’s length standard was inadequate and unsupported. The Commissioner now contends, instead, ‘that in the context of a QCSA, the arm’s length standard does *not* require an analysis of what unrelated parties do under comparable circumstances.’ ... In the Commissioner’s view, Treasury’s detailed explanations regarding its comparability analysis “were merely ‘extraneous observations’ — ‘since Treasury reasonably determined that it was statutorily authorized to dispense with comparability analysis in this narrow context, there was no need for it to establish that the uncontrolled transactions cited by commentators were insufficiently comparable.’”

- (q) “Treasury may well have believed that, given the fundamental characteristics of stock-based compensation in QCSAs, it could dispense with arm’s-length analysis entirely. ... But the APA required Treasury to say that it was taking this position, which departed sharply from Treasury’s previous regulations. ... As we held in *Xilinx*, the previous regulations preserved the primacy of the arm’s length standard and its requirement of comparability analysis.”
- (r) “In amending those regulations, however, Treasury never said — either in the notice of proposed rulemaking or in the preamble accompanying the final rule— that the nature of stock-based compensation in the QCSA context rendered arm’s length analysis irrelevant.”
- (s) The comments submitted to Treasury and the IRS were relevant to the issue of whether “similar transactions under similar circumstances” existed. Any such transactions, as Treasury originally admitted, would “ordinarily provide significant evidence in determining whether a controlled transaction meets the arm’s length standard. ... If Treasury felt these comments were irrelevant, it presumably would have said so. Treasury’s decision to respond to the comments on their merits underscores Treasury’s only justification for eschewing comparability analysis was its belief that no comparable transactions could be found.”
- (t) “The APA’s safeguards ensure that those regulated do not have to guess at the regulators’ reasoning; just as importantly, they afford regulated parties a meaningful opportunity to respond to that reasoning. Treasury’s notice of proposed rulemaking ran afoul of these safeguards by failing to put the relevant public on notice of its intention to depart from the traditional arm’s length analysis.”
- (u) Judge O’Malley said that “the majority also glosses over the Tax Court’s criticism that the final rule applied to all QCSAs but was based only on Treasury’s beliefs about the subset of QCSAs involving ‘high-profit intangibles’ where stock-based compensation is a ‘significant element’ of compensation.... Treasury’s failure to explain this leap and the Commissioner’s failure to defend it provide another reason that the regulation does not satisfy the State Farm standard.”
- (v) Judge O’Malley also agreed with *amicus curiae* Cisco Systems “that under the best reading of § 482, QCSAs are not subject to the [CWI] standard. ... As Cisco points out, the CWI standard applies only to a ‘transfer (or a license) of intangible property,’ which is distinct from a cost-sharing agreement for joint development of

intangibles. The Commissioner’s argument that the [CWI] standard applies to ‘intangible transactions in general, and cost-sharing agreements in particular,’ is inconsistent with the plain language of the statute. Under the only reasonable interpretation of § 482, therefore, the [CWI] standard does not apply to QCSAs.”

9. The Majority Opinion.

- (a) The majority stated that “the purpose of the statute [§ 482] is ‘to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer,’” citing *First Sec. Bank of Utah*. Curiously, the majority stated in the next paragraph that in 1962, the Ninth Circuit collected various allocation standards and “outright rejected the superiority of the arm’s length standard over all others.” *Frank v. Int’l Canadian Corp.*, 308 F.2d 520 (9th Cir. 1962).
- (b) This case, however, was decided a full decade before the U.S. Supreme Court’s decision in *First Sec. Bank of Utah*, which certainly casts doubts on the continuing validity of *Frank*. Further, the Court added in a footnote that The [Ninth Circuit] “later took a hard turn from the flexibility it welcomed in *Frank*, which it limited to situations in which ‘it would have been difficult for the court to hypothesize an arm’s length transaction,’” citing *Oil Base, Inc. v. Commissioner*, 362 F.2d. 212, 214 n.5 (9th Cir. 1966).
- (c) The Court then cited an article stating that before the 1968 regulations the arm’s-length standard had been the “nominal standard under the regulations for some 30 years.” The Court also stated that “Despite the asserted focus on comparability, the arm’s length standard has never been used to the exclusion of other, more flexible approaches. Indeed, a study determined that direct comparables were located and applied in only 3% of the IRS’s adjustments prior to the 1986 statutory amendment.”
- (d) Finally, the Court cited a 1995 article stating that “the [§ 482 arm’s length standard] ... did not work in a large number of cases, and in other cases its misguided application produced inappropriate results. The result was a deliberate decision to retreat from the standard while still paying lip service to it.”
- (e) We and others at Fenwick have been involved in a lot of transfer pricing matters over the past four decades, some in litigation, and respectfully disagree. The arm’s length standard and comparables, even adjusted comparables, play an important role in transfer pricing and in resolving transfer pricing disputes. We would never say that merely “lip service” is paid to these arm’s length rules or that they do or did not work in a large number of cases. Under the

Government's § 482 regulations, they are the rule. We have never dealt with an IRS attorney or Appeals Officer who, to our knowledge, would make those statements. We and they (and our fellow practitioners in the area) are the people in the field who deal with transfer pricing on a regular basis.

- (f) These statements also are not in either of the government's Ninth Circuit briefs. While one of the government's briefs does cite that 1995 article, it does so for a different purpose, and does not use the statement selected by the Court.
- (g) One need only look to the Service's annual statutorily mandated Advance Pricing Agreement program reports to see what happens in the real life transfer pricing world. Nearly 2,000 advance pricing agreements have been executed in the program's 25-year history, a great many of them bilateral agreements with foreign countries. These annual reports describe in significant detail the transfer pricing methods used and the comparables on which these transfer pricing agreements were based. We think it fair to say they were all based on the arm's length standard.
- (h) Further, American taxpayers have been required to annually document their transfer pricing methodologies for 25 years now under the § 6662 regulations. Treas. Reg. § 1.6662-6(d) requires a description of the taxpayer's transfer pricing method and a best method analysis showing why that method is "*the most reliable measure of an arm's length result.*" The documentation also must provide a "description of the comparables that were used, how comparability was evaluated," and so forth. These regulations and the resulting documentation are a very important part of transfer pricing in the real world.¹⁶
- (i) Given this emphasis, it would seem impossible to say that the arm's length standard doesn't work or that it receives only "lip service." The arm's length standard is widely used, and nearly all transfer pricing advance pricing agreements and matters in dispute are resolved or based on this standard and without litigation.
- (j) The majority opinion stated that "Congress intended the commensurate with income standard to displace a comparability analysis where comparable transactions cannot be found." The majority further stated that Treasury "initially" understood the CWI standard to be consistent with the arm's length standard,

¹⁶ In 2018, for example, the IRS's Large Business and International Division ("LB&I") fine-tuned its examination rules regarding this documentation requirement. See LB&I Memorandum 04-0118-006 (Jan. 29, 2018). LB&I stated "Proper selection and application of a transfer pricing method, under Treas. Reg. § 1.482, is critical to enforcement of the arm's length principle."

when it wrote its 1988 White Paper (IRS Notice 88-123, which stated that “intangible income must be allocated on the basis of comparable transactions if comparables exist”).

- (k) That CWI must be applied consistently with the arm’s length standard was not an “initial” IRS understanding. It was strongly set forth 19 years later in the 2007 Chief Counsel’s Memorandum cited above (fn.2), and in numerous treaty technical explanations since that time. Arm’s length is required under the § 6662 regulations, and the arm’s length standard has been applied in nearly 2000 advance pricing agreements.
- (l) The Court stated further that despite use of the phrase “arm’s length standard,” the White Paper signaled a dramatic shift from the standard as it had been defined following the 1968 regulations. This, of course, overlooks the Ninth Circuit’s own statements in *Xilinx*, in which a majority of the panel said the arm’s length standard was the fundamental “purpose” of the § 482 regulations. It also overlooks the IRS’s Advance Pricing Agreement Program and § 6662 regulations.
- (m) The Court stated that “in its notice, Treasury made clear that it was relying on the [CWI] provision in adopting the [2003 Regulation].... It also informed interested parties of its intent to coordinate the new regulations with the arm’s length standard, suggesting that it was attempting to synthesize potentially disparate standards found within § 482 itself.” The Court ultimately held “with its references to legislative history, Treasury communicated its understanding that Congress had called upon it to move away from the traditional arm’s length standard.”
- (n) The IRS seems not to have made this argument in its briefs (where it continued to assert the 2003 Regulation is based on arm’s length principles) but arguably it did so during the oral argument. It argued that “CWI means you look to internal standards” and “you do not look to what unrelated parties do,” although the Service also stated during the oral argument that it doesn’t have the authority to eliminate the arm’s length standard. Of course, the Service did argue in the Tax Court that it had the *authority* to move off the arm’s length standard (which the Tax Court declined to address), but that seemed not to be its argument in the Ninth Circuit, at least in its briefs.
- (o) The Court stated that “Treasury set forth its understanding that it should not examine comparable transactions when they do not in fact exist and should instead focus on a fair and reasonable allocation of costs and income.” Further, “Treasury relied on

Congressional rejection of primacy of the traditional arm's length standard. None of the comments at issue address why Treasury was mistaken in its understanding that it was authorized to use a method that did not include comparables.”

- (p) The Court further stated that “the rulemaking record is sufficient to survive an APA challenge because Treasury’s position is supported by logic and by industry norms. Treasury wrote that parties would not ‘ignore’ stock-based compensation if such compensation were a ‘significant element’ of the compensation costs one party incurs and another party agrees to reimburse. Treasury’s determination is reasonable because parties dealing at arm’s length certainly would not grant stock options to each other’s employees without mentioning the arrangement in the cost-sharing agreement. In other words, parties dealing at arm’s length simply do not share these costs, but related parties, whose stock is commonly owned, do.”
- (q) This statement seems important to the Court’s decision, but also seems non-sensical. Section 482 fundamentally assumes and treats the related parties as unrelated. Thus, in a cost sharing analysis, the parties are not actually or presumed to be granting stock options to each other’s employees. Each party (or only one, as the case may be) issues its own options; the question is whether the costs of those options should be shared. If “parties dealing at arm’s length simply do not share these costs,” as the Court says and as the Ninth Circuit said in its *Xilinx* decision, then the case should be decided for Altera. The last part of the statement “but related parties, whose stock is commonly owned, do” is not in the parties’ briefs, not true to our knowledge in the context of cost sharing, and is contrary to the construct of § 482 and its purpose of parity. Parity is simply not achieved if the result is not what unrelated parties do. Moreover, if it were correct, then there would be no need for the regulation in issue, or for *Xilinx* to have been litigated as a case “designated for litigation,” or otherwise.
- (r) Altera argued that “[t]he assertion that the [CWI] clause supplants that arm’s length standard with a ‘purely internal’ analysis is a sharp – but unacknowledged – reversal from Treasury’s long-standing prior policy.” The Court stated that agencies are free to change their existing policies as long as they provide a reasoned explanation for the change. The Court said this argument was not meaningfully different from Altera’s general APA argument. “If the arm’s length standard allows the Commissioner to allocate costs between related parties without a comparability analysis, there is no policy change, merely a clarification of the same policy.

Moreover, even if the policy changed, it changed well before 2003, as *Xilinx* demonstrates.”

- (s) Thus, the Court held the 2003 Regulation was not arbitrary and capricious under the standards of review imposed by the APA. “Treasury understood § 482 to authorize it to employ a purely internal, [CWI] approach, in dealing with related companies.” The Court also stated that “Treasury’s decision to dispense with a comparability analysis was reasonable” and that “As demonstrated by nearly a century in interpreting § 482 and its precursor, the arm’s length standard is aspirational, not descriptive.”

10. Summary.

- (a) We will be surprised if Treasury and the IRS are happy with their third Ninth Circuit opinion – they didn’t like the Ninth Circuit’s first two opinions on this subject (in *Xilinx*). They got a result in *Altera* that was based on the regulation’s moving off the arm’s length standard, one based on internal analyses only and without regard to what unrelated parties do. It also seems far more broad than applying simply to cost sharing or the transfer or license of intangibles.
- (b) When Treasury and the IRS got a similar result in the first Ninth Circuit opinion (in *Xilinx*), they liked the result but expressed disagreement with the Court’s rationale regarding the government’s ability to write, and having written, a regulation that generates a non-arm’s length result.
- (c) The Ninth Circuit’s panel in *Xilinx*, including Judge Reinhardt who participated on the *Altera* panel, shared the view that the Service’s “sharing of costs” approach was not an arm’s length approach. The IRS seems again to have achieved that same non-arm’s length victory: its regulation authorized, and required, a non-arm’s length result.
- (d) The result, if sustained by the reconstituted Ninth Circuit panel, will likely result in two transfer pricing systems in the US: “East of Rockies” and “West of Rockies” (at least, in the Ninth Circuit). We wonder what the IRS will do in its Advance Pricing Agreement Program and under Treas. Reg. § 1.6662-4 regarding tax return transfer pricing documentation requirements? Will there be two standards, one for EOR and the other for WOR? After all, the law would be different in EOR from the law in WOR.
- (e) It also would be interesting to hear Treasury’s explanations to foreign countries regarding our treaties, and, better yet, its

explanations to the Senate regarding the numerous pending tax treaties. It is the IRS itself, so far, that has won (or forced) the case that led to the two different US transfer pricing systems: EOR is an arm's length system, and WOR is an "internal dealings/ignore comparables/commensurate with income" system.

- (f) This undoubtedly also will open up vast new transfer pricing opportunities, for example, for inbound (foreign based) taxpayers with US subsidiaries. Time will only tell what the future holds.

D. Medtronic.

1. The Eighth Circuit vacated the Tax Court's decision in *Medtronic v. Commissioner*, ___ F.3d ___ (8th Cir. 2018), and remanded the case back to the Tax Court for a comparability assessment.
2. Medtronic used the comparable uncontrolled transactions ("CUT") transfer pricing method to determine the royalty rates paid on its intercompany licenses. To resolve a 2002 audit, Medtronic and the IRS entered into a Memorandum of Understanding ("MOU") on the royalty rates and agreed to apply the royalty rates in future years "as long as there [were] no significant changes in any underlying facts."
3. In 2005 and 2006, the IRS asserted that the comparable profits method – not the CUT method – was the best way to determine an arm's length price for Medtronic's intercompany licensing agreements for those two years resulting in tax deficiencies.
4. Medtronic filed in Tax Court, arguing that the CUT method, not the comparable profits method, was the best method for determining an arm's length price for the intercompany licenses. The Tax Court found that the comparable profits method downplayed Medtronic Puerto Rico's role in ensuring the quality that it did not reasonably attribute a royalty rate to Medtronic's profits, that it used an incorrect return on assets approach, that it improperly aggregated the transactions, and that it ignored the value of licensed intangibles. Similarly, the Tax Court concluded that Medtronic's CUT method did not produce an accurate arm's length adjustment because it did not distinguish between devices and leads and therefore produced a result that was unconvincing and overly broad.
5. The Tax Court then engaged in its own valuation analysis. It ultimately decided that Medtronic's CUT method was the best way to determine an arm's length royalty rate for intercompany agreements, but made a number of adjustments.
6. The Eighth Circuit reviewed the Tax Court's de novo for legal conclusions and mixed questions of law and fact and reviewed factual findings under the clear error standard.

7. The Tax Court applied the Pacesetter agreement as the best CUT to calculate the arm's length result for intangible property. The Pacesetter agreement was entered into by Pacesetter's parent company and Medtronic US in 1992 in an effort to settle several lawsuits regarding patent and license use. As part of the agreement, the parties cross-licensed their pacemaker and patent portfolios.
8. The Tax Court determined that the Pacesetter agreement was an appropriate CUT because it involved similar intangible property and had similar circumstances regarding licensing. The Eighth Circuit concluded that the Tax Court's factual findings are insufficient to enable the Eighth Circuit to conduct an evaluation of that determination.
9. The Eighth Circuit stated that the Tax Court did not address in sufficient detail whether the circumstances of the settlement were comparable to the licensing agreement.
10. Additionally, the Eighth Circuit stated that the Tax Court did not analyze the degree of comparability of the contractual terms.
11. The Eighth Circuit stated that the Tax Court also did not evaluate how the different treatment of intangibles affected the comparability. The Pacesetter agreement was limited to patents and excluded all other intangibles, including "any technical know-how or design information, manufacturing, marketing, and/or processing information or know-how, designs, drawings, specifications, software source code or other documents directly or indirectly pertinent to the use of the Licensed patents." The Medtronic Puerto Rico licensing agreement on the other hand, did not exclude such intangibles.
12. The Tax Court made a 7% adjustment of the "know how" that Medtronic Puerto Rico received from Medtronic, as well as a 2.5% adjustment to account for the differences in licensed products, however, the Eighth Circuit stated it could not determine that appropriateness of using the Pacesetter agreement as a CUT without additional findings regarding the comparability of the remaining intangibles.
13. Finally, the Eighth Circuit stated that the Tax Court did not decide the amount of risk and product liability expense that should be allocated between Medtronic US and Medtronic Puerto Rico.

E. Amazon Appeal.

1. The IRS filed a Notice of Appeal in *Amazon v. Commissioner*, 148 T.C. No. 8 (2017). This apparent effort to appeal the Tax Court's decision is as surprising a development as was the government's decision to file an appeal in *Medtronic v. Commissioner*. Apparently, after losing a string of

§ 482 cases at the Tax Court level, the IRS has decided to try another judicial forum to seek a victory.

2. The issue isn't with the Tax Court. The court in these cases clearly weighed all the factors and evidence involved, heard arguments on both sides and reached a conclusion.
3. The problem is that the IRS has been way too aggressive regarding the transfer pricing rules. For example, in some situations discussed in this outline the U.S. told the BEPS draftspersons one thing regarding what the rules should be, and Treasury and/or the IRS turned around and made completely contrary arguments in court or rules in regulations. The IRS also has ignored its own prior settlement agreements in some cases, as discussed elsewhere in this Section I.

F. Coca Cola.

1. In *Coca-Cola Co. et al v. Commissioner*, T.C. Dkt. 31,183-15, the Tax Court denied the IRS's Motion for Partial Summary Judgment on September 7, 2017. The case is calendared for trial beginning on March 5, 2018. The IRS made transfer-pricing adjustments under § 482 that produced aggregate deficiencies in excess of \$3.3 billion for Coca-Cola's 2007-2009 taxable years. In the Summary Judgment Motion the IRS unsuccessfully asked the Court to hold as a matter of law that a 1996 closing agreement had no conceivable relevance to any issue before the court.
2. In the closing agreement, the parties agreed to a methodology (the "10-50-50 method") for calculating profits to foreign affiliates. Under this method the foreign affiliates would retain 10% of gross revenues as a routine return, and the residual operating income (after certain adjustments) would be split 50%-50%. The closing agreement covered Coca-Cola's tax years up to and including 1995.
3. The closing agreement also provided penalty protection both during the term of the agreement and for tax years after 1995. The closing agreement provided that, if Coca-Cola continued to calculate royalties in accordance with the 10-50-50 method or another method to which the parties subsequently agreed, then Coca-Cola would be deemed to have met the "reasonable cause and good faith" exception to the penalties in §§ 6662(e)(3)(D) and 6664(c).
4. Coca-Cola continued to use the 10-50-50 method to compute product royalties through 2009. For 1996-2006, the IRS accepted Coca-Cola's application of the 10-50-50 method and (with one exception) made no § 482 adjustments to the product royalties. However, during the 2007-

2009 examination, the IRS determined that the transfer prices using the 10-50-50 method were not arm's-length.

5. The Tax Court held that the execution of the closing agreement was a historical fact and provides the obvious starting point for any narrative of the events leading up to the 2007-2009 audit. The Tax Court stated that 10-50-50 method prescribed by the closing agreement is the method that Coca-Cola used when computing its taxable income for the years at issue and this alone gives the closing agreement relevance.
6. The closing agreement also had relevance in addressing an issue involving the creditability of a Mexican tax on the profits of a Mexican branch. The branch's income was based on the methodology set forth in the closing agreement.
7. The Tax Court stated that the IRS's summary judgment motion to exclude the closing agreement was "odd." The IRS did not file a motion in limine seeking to exclude the closing agreement from evidence on relevance grounds. Rather, the IRS filed a Motion for Partial Summary Judgment seeking a ruling that a historical fact, as a matter of law, can have no conceivable relevance to any issue before the Court.
8. The Tax Court doubted that this was a proper subject for summary judgment because the IRS did not seek summary adjudication in its favor on one or more of the "legal issues in controversy." The Tax Court stated that it would be imprudent for a court to grant a summary judgment motion of this sort six months before hearing any evidence at trial. While the Tax Court questioned whether the IRS's Motion for Summary Judgment was proper it still denied the motion on its merits.
9. The issue and the IRS's position bears a striking conceptual similarity to three prior cases in which the court seemingly followed a prior transfer pricing agreement between the taxpayer and the IRS that the IRS decided it no longer liked. In *Eaton v. Commissioner*, T.C. Memo. 2017-147 (2017), the Tax Court criticized the IRS for cancelling APAs retroactively stating that the IRS's desire to change the underlying agreed upon transfer pricing method was an abuse of discretion. In *Medtronic Inc. v. Commissioner*, T.C. Memo. 2016-112 (2016, on appeal) and *Eli Lilly v. Commissioner*, 856 F.3rd 855 (7th Cir. 1988), there also were prior transfer pricing-agreements between the taxpayer and the IRS that the IRS subsequently decided it no longer liked and instead asserted large tax deficiencies.
10. In all three cases the IRS lost when it deviated from its prior agreement with the taxpayer. In all three cases the Courts' transfer-pricing conclusions were basically those to which the parties had previously agreed, with slight modifications. While the case in *Coca-Cola* has not

reached its ultimate conclusion, the Court does seem interested in the parties' prior agreement.

11. The IRS undoubtedly is concerned that the Tax Court will take an approach similar to that which it took in the prior cases involving taxpayer-IRS agreements, and thus it tried unsuccessfully to have the Court exclude the prior agreement as a matter of law.
12. Situations where something that once seemed like a good deal no longer looks so good to one of the parties to an agreement are sometimes described as involving "seller's remorse" or "buyer's remorse." However, for this to happen repeatedly¹⁷ and with such drastic changes in the IRS's position (multi-million and billion dollar adjustments) suggests a much greater problem than simply "seller's/buyer's remorse."

G. Annual APA Report.

1. The IRS released its advance pricing agreement ("APA") report for 2017. Similar to 2016, the number of new applications in 2017 (101) was significantly lower than in previous years. The number of pending APAs has continued to decline since 2015. Taxpayers seem less interested in applying for APAs than in the past. The IRS has been receiving fewer applications and working through its inventory.
2. The median processing time for completing an APA rose an additional month to about 34 months. The number of APA team leaders, economists and managers dropped.
3. Of the 116 agreements executed, 40 percent were new APAs, which is consistent with prior years. The volume and type of applications received, the types of transactions covered, and the transfer pricing methods used was largely consistent with prior years.
4. There were 86 bilateral APA applications: 38 percent involved Japan, 21 percent involved India, and 8 percent involved Canada. Bilateral APA requests for India started in 2016, creating a boon in applications (34 percent in 2016).

H. Transfer Pricing Directives.

1. An IRS official stated that the IRS is reevaluating its approach to transfer pricing enforcement and litigation after recent losses in court. Kirsten Wielobob, Deputy Commissioner for Services and Enforcement, said the Service is looking at how it assesses and selects cases for examination and how it analyzes issues. Wielobob said the IRS cannot continue to do things as it currently does them.

¹⁷ We have experienced this same situation in cases subsequently resolved in Appeals.

2. The IRS is facing resource constraints. In addition, the IRS has received clear messages from the courts on the IRS's approach to transfer pricing. Wielobob spoke at the November 30, 2017 annual international tax conference sponsored by George Washington University Law School, the IRS and the Treasury Department.
3. The IRS really does need to reevaluate its approach to transfer pricing. We have expressed this view for some time, in particular, regarding the extreme positions the IRS sometimes takes (reneging on prior transfer pricing agreements, taking positions contrary to those the U.S. took in BEPS negotiations, etc.). Litigating *Amazon* to effectively re-litigate *Veritas* would seem to have been a waste of government resources. Appealing *Amazon*, *Medtronic* and *Altera* would also seem to be a waste of government resources.
4. Transfer Pricing Approval Required for Changing the Taxpayer's Selection of a Transfer Pricing Method as the Best Method.
 - (a) The first new Directive (LB&I-04-0118-002), dated Jan. 12, 2018, and updated (LB&I-04-0118-006), dated Jan. 29, 2018, establishes a new approval process before the transfer pricing method used by the taxpayer can be changed. The approval must be granted by the Treaties and Transfer Pricing Operations ("TTPO") Transfer Pricing Review Panel before the transfer pricing method used in the taxpayer's contemporaneous transfer pricing documentation or an Advance Pricing Agreement ("APA") submission can be changed. The required approval process set forth in the Directive does not apply when the examiner changes the application of the taxpayer's best method – it only applies when the examiner changes the taxpayer's selection of its method as the best method. The approval process in the Directive applies to examinations of LB&I taxpayers (i.e., assets equal to or greater than \$10,000,000) who are required to file forms 5471 or 5472 and taxpayers in the APA program.
 - (b) The Directive acknowledges that proper selection and application of a transfer pricing method is critical to the enforcement of the arm's length principle. To ignore the taxpayer's transfer pricing analysis and conclusion and to start the best method selection analysis from scratch protracts the examination timeline and diverts resources. The Directive requires the examination team to start with the taxpayer's selection of the best method, and thoroughly analyze the taxpayer's application of their selected method. If the examination team concludes that changes to the application of that method are appropriate, the changes need to be thoroughly developed and documented as early as possible.

- (c) The Directive only applies in cases where the taxpayer has timely provided § 6662 transfer pricing documentation clearly stating the method the taxpayer has selected is the best method and the analysis to support that conclusion. The use of an unspecified method may warrant a higher level of additional scrutiny by the examination team.
- (d) The assigned APA team must also start with a thorough review of the taxpayer’s analysis and conclusion regarding its selection of the best method in the case of a unilateral APA request or its selection of the “most appropriate method” under the OECD Transfer Pricing Guidelines in the case of bilateral APA requests. Once the APA team has begun formal negotiations with a competent authority on a bilateral APA, the approval process in the Directive is not required. In the case of an APA where an alternative method is warranted, the recommendation for a method change must be elevated through the management chain to the applicable Director of Field Operations (“DFO”) level for referral to the national TTPO Transfer Pricing Review Panel.
- (e) The TTPO Transfer Pricing Review Panel will consist of the TPP Director or APMA Director (depending on whether the case is an APA or an examination), a Senior Advisor to the TTPO Director, and the Income Shifting Practice Network Manager. Key questions the Review Panel will focus on include: (1) Why the taxpayer’s method is unreliable, (2) Whether the taxpayer’s method can be adjusted to make it more reliable, and (3) If not, what method is more reliable, and why. The method-change recommendation must include the analysis supporting the alternative method selection and provide the Review Panel with support for answers to the questions.

5. New Stock-Based Compensation Audits are Suspended.

- (a) Directive (LB&I-04-0118-005), dated Jan. 12, 2018, instructs examiners to stop opening issues on stock-based compensation (“SBC”) included in cost-sharing arrangement (“CSA”) intangible development costs until the Ninth Circuit issues an opinion in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015).
- (b) In *Altera*, the Tax Court invalidated Treasury’s final cost sharing regulations which required the inclusion of SBC when determining operating expenses under a qualified CSA. Both the Tax Court and the Ninth Circuit had previously invalidated a 1995 version of similar regulations in *Xilinx Inc. v. Comm’r*, 125 T.C. 37 (2005), *aff’d*, 598 F.3d 1191 (9th Cir. 2010). The government has appealed *Altera* and oral argument was heard in October 2017.

- (c) For CSA examinations where the SBC issue is already being developed by the examination team, if the taxpayer agrees to extend the statute of limitations for a period long enough to allow for the results of *Altera* to be known and for any additional development work, then issue development will be stopped. If the taxpayer does not agree to extend the statute of limitations, then development of the issue will continue.
- (d) The Directive limits the focus of CSA examinations regarding SBC, examination and adjustments related to other CSA issues, including other IDC issues, are not limited by the Directive.

6. Changing Multiple RAB Shares.

- (a) Directive (LB&I-04-0118-004), dated Jan. 12, 2018, instructs examiners to stop developing adjustments based on changing a taxpayer's multiple reasonably anticipated benefits ("RAB") shares to a single RAB share when subsequent platform contribution transactions ("PCTs") are added to an existing CSA until an agencywide position is finalized.
- (b) U.S. participants in a CSA frequently acquire companies with valuable intangible property, and then make the acquired IP available to the foreign CSA participant through a subsequent PCT contribution.
- (c) There are three different potential ratios of RAB shares that could be used in the CSA: the existing RAB shares under the existing CSA, the shares of incremental profits related to the IP made available to the CSA by the subsequent PCT, and updated RAB shares that would result after the newly acquired IP is contributed to the existing CSA and combined with the IP already covered by that CSA. Some examination teams have taken the position that the RAB share regulations under Treas. Reg. § 1.482-7 require use of a single RAB share for such subsequent PCTs.
- (d) The Service is currently reviewing this issue to determine a consistent Service-wide position. Including in this review is how to incorporate subsequent PCTs into the RAB share of an existing CSA and determine what RAB shares should be allowed under all PCT valuation methods.
- (e) In the interim, the Directive instructs examination teams not to develop adjustments based solely on changing a taxpayer's multiple RAB shares to a single RAB share.

7. Transfer Pricing Penalties.

- (a) Directive (LB&I-04-0118-003), dated Jan. 12, 2018, deals with the application of § 6662(e) penalties in certain transfer pricing exams. The Directive states that appropriate application of penalties when documentation is inadequate maintains accountability and encourages reasonable and well-documented return positions that may be assessed more efficiently, saving resources for both the IRS and taxpayers.
- (b) The Directive also states that having IRC § 6662(e) documentation does not automatically protect against penalties. To meet the reasonable cause exception of the penalty regulations, taxpayers must document they reasonably selected the best method for their analysis and they reasonably applied that best method. When the documentation does not explicitly include a best method analysis and conclusion, penalties apply if the adjustments exceed the penalty threshold.
- (c) The Directive states that the examination team should be probing for data and information that the taxpayer had access to or should reasonably have identified and considered at the time of the transaction to determine if the taxpayer adequately searched for, considered and applied the relevant body of information and whether the taxpayer adequately incorporated and addressed that data in its § 6662(e) documentation analysis.
- (d) The Directive states that the evaluation of the applicability of penalties should be undertaken after the examination team has completed enough of its analysis to know the order of magnitude of the potential adjustment and has a deep factual background. The Directive encourages examiners to complete a diligent penalty analysis.

I. IRS No-Rule List: § 1059A.

- 1. In Rev. Proc. 2018-7, 2018-1 IRB 271, the IRS has provided a revised list of matters in which it will not issue letter rulings or determination letters. A new section in § 4.01(26) was added relating to § 1059A. There are no other changes except renumbering.
- 2. Section 1059A is a limitation on taxpayer's basis or inventory cost in property imported from related persons. The no-rule issue is whether a taxpayer's cost or inventory basis in property imported from a foreign affiliate will not be limited by § 1059A due to differences between customs valuation and tax valuation.

3. We had this issue raised in an audit a few years ago in a somewhat bizarre manner, and the issue was fully resolved in the taxpayer's favor in Appeals, as we thought it should have been. It involved a U.S. parent company and sales to it by a foreign subsidiary.

J. Peking Investment: § 482 "Control."

1. *Peking Investment Fund LLC v. Commissioner*, T.C. Dkt. No. 12772-09 (Order 2018), involved the Service's disallowance of a partnership's loss stemming from the exchange of an interest in one portfolio of nonperforming loans for another. We will address only the Service's assertion that § 482 applied. This issue previously was addressed in *Austin Investment Fund LLC v. United States*, ____ F. Supp. ____ (D.D.C. 2015).
2. In *Austin*, a district court granted the government's motion for summary judgement disallowing a similar loss on the basis of § 482. The court held in *Austin* that a transaction that took place in China between two entities there was subject to § 482 because § 482 by its terms applies to entities "whether or not organized in the United States." It applied to transactions between the Bank of China and another company, China Orient, even though neither party was organized in the United States and neither was before the court.
3. In *Peking Investment Fund*, disposing of the motion for summary judgment did not require a resolution of the legal issue as to whether § 482's reach extends to transactions between "non-taxpayers," because the IRS had not established that the entities in China were under common ownership or control when the relevant portfolio exchange took place. The IRS argued that the taxpayer did not dispute that the two entities in China were both owned by the Chinese government. To the contrary, the taxpayer claimed that an affidavit that it submitted that the two entities were not co-owned by the Chinese government as a matter of fact.
4. While the court did not read that affidavit as establishing the point for which the taxpayer invoked it, the court nonetheless took the taxpayer's claim as an indication that it did not concede that the entities were under common ownership within the meaning of § 482 at the time of the transaction between them. Common ownership, for this purpose, can be either direct or indirect, but the ownership, in either case, should be clear.
5. The court was unconvinced that the "amorphous" common ownership was sufficient to authorize the IRS to make adjustments under § 482. The court cited a previous case (*Southgate Master Fund LLC v. United States*, 651 F. Supp 596 (N.D. Tex 2009), *aff'd* on other grounds, 659 F.3d 466 (5th Cir. 2011)) recognizing the entities' ownership by the Chinese government but reasoning that the "bright line between state ownership

and enterprise management” allowed each entity to treat its property and assets as its own. Thus, the Tax Court denied the IRS’s motion for partial summary judgment that § 482 allowed the Service to disallow the loss in question.

K. Broadwood Investment: § 482 “Control.”

1. In *Broadwood Investment Fund LLC v. United States*; No. 8:08-cv-00295, the court denied the government partial summary judgment on § 482 adjustments that limited partnerships’ inside basis in portfolios of Chinese nonperforming loans. This is the issue that also was addressed in *Peking Investment Fund LLC v. Commissioner*, T.C. Dkt. No. 12772-09 (Order 2018) and *Austin Investment Fund LLC v. United States*, ____ F. Supp. ____ (D.D.C. 2015).
2. At least four courts have now addressed the question of whether the Chinese government had common ownership or control over China’s Banks under § 482. In *Southgate Master Fund LLC v. United States*, 651 F. Supp. 2d 596, 647 (N.D. Tex. 2009), *aff’d on other grounds*, 659 F.3d 466 (5th Cir. 2011), the district court held that they were not “commonly controlled entities” for the purposes of § 482.
3. In the second case, *Austin*, the district court reached a contrary result, granting summary judgment in favor of the government holding they were under common ownership of the Chinese government for purposes of § 482.
4. In *Peking*, the courts disposed of the motion for summary judgment. The Tax Court was unconvinced that the “amorphous” common ownership was sufficient to authorize the IRS to make adjustments under § 482.
5. In this new *Broadwood* case the district court held that given the factually intensive and far-reaching questions involved in the common control inquiry at hand, it would be premature to resolve this issue at summary judgment.

L. Transfer Pricing Guidance.

1. The IRS Large Business & International Division issued new guidance on the Transfer Pricing Examination Process (“TPEP”) providing best practices and insights about what can be expected during an examination. With the issuance of the TPEP, the Transfer Pricing Roadmap is retired.
2. The guide will be provided at the start of a transfer pricing examination and serve as a framework and guide. The IRS stated that the TPEP is not a checklist or a one-size fit all tool. It is only a guide – not a set of required steps.

3. The TPEP states that transfer pricing examinations are factually intensive and require a thorough analysis of functions, assets, and risks along with an accurate understating of relevant financial information. To ensure resources are applied effectively, LB&I is using data analytics to identify issues for examination that have the most significant risk for non-compliance. In addition, it recommends that teams continually assess the merits of issues during an examination and continually assess opportunities for issue resolution with taxpayers during the examination process.
4. Hopefully, the TPEP will encourage exam teams to better assess the merits of transfer pricing cases, including considering recent court case decisions, and work better than the Transfer Pricing Roadmap, but that may be over optimistic since the TPEP is only a guide and not a set of required procedures.
5. The TPEP stresses the importance of collaboration and coordination in the planning phase and also the use of practice units as reference tools.
6. In the initial transfer pricing risk assessment phase, the TPEP states that the exam team needs to review prior year workpapers and income tax returns. Exam is also instructed to analyze the country-by-country report as a tool to provide useful information to analyze high level transfer pricing risk, Base Erosion and Profit Splitting (“BEPS”) related risk, and when appropriate, conduct further economic and statistical analysis. Before analyzing the CbC report, the exam team members are required to complete CbC training.
7. In the planning phase, exam is instructed to compute key financial ratio analysis for multiple years, make industry comparisons, and consider whether there is potential cross border income shifting. The TPEP states that this may be useful as a diagnostic tool; however, is not a definitive indication of the arm’s length nature of controlled transactions.
8. In order to understand the history, background, overall core business operations, and profit drivers, the TPEP recommends reviewing the company website, Securities and Exchange Commission (“SEC”) filings, and search the company’s name on the internet. It is important for companies to be aware of what is stated in filings and on the internet.
9. In terms of developing a working hypothesis, the TPEP cautions that unadjusted industry average returns should only be used to assess transfer pricing risk and on their own should not be used to make a transfer pricing adjustment.
10. For planning meetings, the TPEP recommends general agenda items including timeframes, key milestones, and topics specific to the transfer

pricing examination. The TPEP states that exam teams should conduct weekly or bi-weekly discussions with the taxpayer to support communication and ensure common expectations regarding the audit, progress, IDRs, and timelines.

11. The execution phase includes determining the facts, applying the law to those facts, and understanding the various tax implications of the issue. In the execution phase the exam team should conduct interactive discussions, including using the IDR process. Every effort should be made to resolve any factual differences. Open communication and continuous reassessment should continue throughout the execution phase. This was encouraged in the Transfer Pricing Roadmap as well.
12. In terms, risk assessment, the exam team will review and analyze the § 6662(e) documentation prior to the orientation meetings and note areas that require further development, confirmation, or inquiry and whether the conclusions can be considered reasonable.
13. In the execution phase, the exam team will prepare and issue an IDR requesting a transfer pricing and a supply chain orientation meeting. The exam team will also request any additional information not obtained during the planning phase and issue IDRs or summonses for factual development, including requests for interviews, plant tours, and site visits. The exam team is also instructed to review intercompany agreements and conduct functional analysis.
14. The exam team is encouraged to work with the economist to perform an economic analysis. The TPEP states that penalties should be considered whenever adjustments are made. This is consistent with the IRS's new directive on Transfer Pricing penalties.
15. The TPEP states that an acknowledgement of facts IDR should be issued for all transfer pricing issues (whether potentially agreed or unagreed). Exam should revise the Economist's Report and NOPA based on additional taxpayer input, as appropriate.
16. The goal of the resolution phase is to reach agreement, if possible. The resolution phase section discusses case closing, appeals, and competent authority.

XIII. FOREIGN TAX CREDITS NON-TAX ACT DEVELOPMENTS.

A. Coca-Cola Foreign Tax Credit Case.

1. The Tax Court in *Coca-Cola Company v. Commissioner*, 149 T.C. No. 21 (December 14, 2017), granted Coca-Cola partial summary judgment allowing foreign tax credits for Mexican taxes paid by a branch ("Mexico Licensee") on income that is subject to an IRS adjustment under § 482.

2. In 2015, the IRS issued a notice of deficiency for the taxable years 2007-2009 asserting that the royalties the Mexico Licensee paid to the U.S. were too low and not calculated at arm's length. If the royalties the Mexico Licensee paid to the U.S. are successfully increased by the IRS under § 482, the adjustment would reduce the Mexico Licensee's income, the corresponding Mexico income taxes and the corresponding foreign tax credits. The IRS asserted that the Mexico Licensee overpaid its Mexican income tax and therefore the taxes were not "compulsory" and thus not "taxes" within the meaning of § 901. The Tax Court held that the Mexican taxes were "compulsory" levies and that the IRS erred as a matter of law in disallowing the foreign tax credits.
3. The IRS and Coca-Cola entered into a closing agreement that established a "10-50-50 method"—for calculating royalties. The closing agreement covered taxable years 1987-1995. Under the 10-50-50 method each supply point would retain 10% of its gross sales as a routine return, and the residual operating profit (after certain adjustments) would be split 50-50 between the supply point and Coca-Cola.
4. The closing agreement did not apply after 1995 except that it provided if Coca-Cola continued to use the agreement's methodology thereafter it would be deemed to have satisfied the "reasonable cause and good faith" exception to the § 6662 penalty. Coca-Cola continued to use the agreement's methodology through 2009. For years through 2006, the IRS accepted the methodology and, with one exception, made no § 482 adjustments to the product royalties.
5. In continuing to calculate royalties under the 10-50-50 method, the Mexico Licensee and Coca-Cola relied on advice from a Mexican tax attorney. The Mexican tax attorney advised the Mexico Licensee to continue paying royalties under the 10-50-50 method since there had been no changes in operations or the transactional relationship sufficient to justify a higher royalty rate. The Mexican tax attorney advised that the SAT (Mexico's federal taxing authority) would not permit the Mexico Licensee to reduce its Mexican income tax by paying higher royalties, especially since all of the supply points continued to pay royalties calculated under the 10-50-50 method.
6. Two requirements must be satisfied in order for a foreign tax payment to be considered "compulsory and creditable under § 901." First, the payment must be made based on a reasonable interpretation and application of foreign law (including applicable tax treaties). Second, the taxpayer must exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce the taxpayer's liability for foreign tax. The regulations do not specify what constitutes a "reasonable interpretation and application" of foreign law. But they do provide a safe harbor by

allowing taxpayers to rely on good-faith advice from a competent tax professional. The IRS did not dispute that the Mexico tax attorney Coca-Cola used was competent tax professional.

7. The IRS's principal argument was that Coca-Cola could not rely on the advice in good faith because the Mexican attorney based his advice on incomplete facts. Under the IRS's view, the IRS's subsequently proposed transfer pricing adjustment in the case was a fact that was not considered by the Mexican attorney. However, the earliest date on which the IRS informed Coca-Cola that it might challenge the pricing was January 26, 2011, well after Coca-Cola filed its tax returns for 2007-2009.
8. The IRS contended that the timing of the notice of proposed adjustment was irrelevant and that Coca-Cola was retroactively "on notice" as of 2007-2009. The Tax Court stated that "[t]his argument is hard to take seriously." The regulations clearly indicate that the judgment as to whether an interpretation of foreign law "is likely to be erroneous" is to be made at the time the foreign tax is paid. A taxpayer cannot have had actual or constructive notice of a fact during 2007-2009 when the communication that put it on notice did not occur until 2011.
9. The IRS also argued that between 2001 and 2006 Coca-Cola shifted a significant portion of the Mexico Licensee's manufacturing operation to a supply point in Ireland and that the Mexican tax attorney did not properly take this into account when rendering his advice. The Tax Court was also not persuaded by this argument. The Tax Court stated that the IRS approved the use of the 10-50-50 method through 2006. During this 20-year period the revenues and profits may have undergone significant year-to-year changes. There is nothing in the original closing agreement or in subsequent IRS audit activity to suggest that the 10-50-50 formula was supposed to change depending on such variables.
10. Furthermore, the Tax Court stated that given how the 10-50-50 formula worked, production shifts were irrelevant. Annual variations in a supply point's revenues or profits were irrelevant under the 10-50-50 method. The court stated that whether the Mexican tax attorney was informed of, or evaluated the effect of, the production shift to Ireland is not a material fact.
11. The IRS further contended that the descriptions of the Mexico Licensee's functions, assets, and risks supplied to the SAT may differ from the facts ultimately found at trial. The Tax Court stated that the transfer pricing dispute trial may affect the merits of the § 482 adjustments but the facts ultimately found at trial are not relevant in ascertaining whether the relevant facts were disclosed to the Mexican tax attorney at the time the advice was given. The Tax Court stated that the Mexican tax attorney

obviously could not have known during 2007-2009 what facts would be established in a trial in 2018.

12. The Tax Court held that Coca-Cola relied in good faith on advice that it obtained and at the time the advice was received and that it did not have “actual notice or constructive notice” that the interpretation of Mexican law was “likely to be erroneous.”
13. The IRS argued that under the second half of the regulatory test requiring a “compulsory” tax, Coca-Cola did not exhaust all effective and practical remedies, including invocation of competent authority procedures. Coca-Cola responded stating that the IRS’s reliance on § 482 adjustments that have not yet been adjudicated, combined with the IRS’s refusal to participate in competent authority proceedings, means that Coca-Cola had exhausted its available remedies.
14. The Court agreed with Coca-Cola that there was no effective and practical remedy that Coca-Cola could pursue to reduce its liability for Mexican tax. If the Mexico Licensee were to file a refund claim in Mexico, that claim would be premature because the IRS’s proposed § 482 adjustments had not yet been adjudicated.
15. Even if a refund claim were not premature, there was no reason to believe that the Mexican government would agree with the IRS’s reallocation of income. The Court stated that a taxpayer “is not required to take futile additional administrative steps: in order to satisfy the exhaustion-of-remedies requirement. The Court cited *Schering Corp. v. Commissioner*, 69 T.C. 579, 602 (1978) (holding Swiss income tax creditable notwithstanding a disagreement between Switzerland and the United States concerning the underlying tax issue).
16. The Court concluded that Coca-Cola’s pursuit of a refund claim in Mexico before the IRS’s § 482 claims were adjudicated would be futile. Nothing in the regulatory framework requires taxpayers to wait until the litigation and its aftermath have finally concluded in order to claim FTCs for foreign taxes they have paid. The Court stated that “[I]f the IRS considers that protection of the public fisc requires prohibiting foreign tax credits until the taxpayer exhausts its litigation remedies, the IRS should seek an amendment to the final regulations. That is a task for the IRS, not this court.” The Court cited *IBM Corp.*, 38 Fed. Cl. at 675. The Court held that “Congress did not intend that FTCs would be denied up front because of the possibility that foreign taxes might in the future be refunded. Rather, Congress envisioned that the accounts would be squared if and when foreign taxes are in fact refunded.”

B. Practice Unit: Exhaustion of Administrative Remedies.

1. The IRS issued a practice unit entitled “Exhaustion of Administrative Remedies” which addresses foreign tax credit issues in the context of establishing that a foreign tax constitutes a creditable foreign income tax for U.S. purposes.
2. Prior cases addressing this issue indicate that the most important single element in this regard is the reliance on counsel in a particular foreign country. *See Coca-Cola v. Commissioner*, 149 T.C. No. 21 (2017); *Vento v. Commissioner*, 147 T.C. No. 7 (2016); and *Procter & Gamble v. United States*, 2010-2 USTC ¶ 50,593 (DC Ohio 2010). Only *Procter & Gamble* is considered in the practice unit.
3. The practice unit states that in order for a foreign tax to be creditable under § 901, it must be compulsory. A payment is compulsory if it is required under the taxing authority of a foreign government. Treas. Reg. § 1.901-2(e)(2) states, “An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated or forgiven if the amount is not greater than a reasonable approximation of the final tax liability to the foreign country.”
4. Treas. Reg. § 1.901-2(e)(5) states that foreign taxes are “not paid” to the extent that payments to a foreign taxing jurisdiction have exceeded the amount reasonably owed under foreign law, or if the taxpayer has failed to claim a reduced treaty rate. If, for whatever reason, taxpayers have overpaid their foreign taxes, they must prove that they exhausted all effective and practical remedies to contest the liability and seek a refund for those taxes. Failing to exhaust these remedies will cause that portion of the foreign tax to be ineligible for the foreign tax credit.
5. In one of the examples in the practice unit, the taxpayer claims the benefit of a treaty by filing a refund with the foreign country for over withholding. The foreign country rejected the claim. The taxpayer then invoked the competent authority procedures of the treaty, the cost of which is reasonable in view of the amount in issue and the likelihood of success is good. Still, the refund was rejected. The cost of pursuing any judicial remedy in the foreign country would be unreasonable in light of the amount at issue and the likelihood of success. The example concludes that the overpayment is now a compulsory payment and may be eligible for the foreign tax credit.
6. The practice unit states that Treas. Reg. § 1.901-2(e)(5) provides that relying in good faith on advice from competent foreign tax advisors, and after disclosing all relevant facts to those advisors, the taxpayer should

make a reasonable interpretation of foreign law provisions in order to establish an entitlement to the foreign tax credit.

7. The taxpayer's exhaustion of remedies should be practical and cost efficient in relation to amounts at issue and likelihood of success. Reasonable costs can be an issue because the amount in controversy may not justify spending a lot of resources to contest an item. Taxpayers may ordinarily take a reasonable business approach, weighing costs and benefits, in settling foreign income tax issues.
8. The regulations specifically state that settlement of more than one issue will be evaluated on an overall basis in determining whether the settlement payment is compulsory or noncompulsory. For example, if the taxpayer settles multiple issues with a foreign country, then the settlement should be evaluated on an overall basis rather than on an issue-by-issue basis.
9. In addition, taxpayers are not required to alter their form of doing business, their business conduct or any business transaction to reduce their foreign tax liability. However, foreign tax payments might be deemed voluntary, and therefore noncompulsory, if the taxpayer has taken options under foreign law that result in an increased tax liability over time.
10. In the practice unit's "steps," the following questions are raised: "How is the exhaustion of remedies analysis affected where a tax treaty applies?" and "Can there be an exhaustion of remedies in a treaty country if a taxpayer does not invoke the right to competent authority assistance?"
11. The practice unit states that if the taxpayer is subject to double taxation or taxation inconsistent with the treaty, the taxpayer must pursue reasonable remedies, including competent authority assistance, if the cost is reasonable in light of the amount in dispute and likelihood of success. While the practice unit does not discuss *Procter & Gamble* in this context, Procter & Gamble relied on the advice of Korean counsel with respect to certain Korean withholding tax. The taxpayer satisfied the requirement that it must exhaust its remedies. The court did not require the taxpayer to seek competent authority relief.
12. The practice unit states that, "Because the cost of pursuing competent authority relief is generally low, taxpayers that fail to seek competent authority assistance where available must produce evidence to show why it would not have been an effective and practical remedy." In *Procter & Gamble*, presumably the advice from reputable Korean counsel was sufficient.
13. The fact that the taxpayer has sought competent authority assistance but obtained no relief generally will not, in and of itself, demonstrate that the taxpayer has exhausted all effective and practical remedies to reduce the

taxpayer's liability for foreign tax. The potential effectiveness of administrative and judicial remedies in the foreign country must also be considered.

14. The practice unit states that competent authority should be consulted as to whether a particular settlement was reasonable based on its prior experience and thus persuasive as to whether the taxpayer exhausted all available remedies.
15. While the practice unit acknowledges that there can be an exhaustion of remedies in a treaty country if the taxpayer does not invoke the right to competent authority assistance, it also states that there are only a few exceptions to this rule and they are narrowly drawn. There are circumstances where competent authority assistance may not be necessary, such as de minimis cases, cases where other administrative remedies or litigation are successful, cases where the taxpayer has received an opinion of local counsel or otherwise has complied with foreign laws to minimize taxes.
16. Section 6.04 of Rev. Proc. 2015-40 involves U.S.-initiated adjustments under the simultaneous appeals procedure. Under this scenario, it is clear that a U.S. taxpayer cannot claim a corresponding adjustment without the involvement of the U.S. competent authority.
17. The practice unit states that in the event the foreign taxes are not treated as tax payments under exhaustion of remedies principles, the taxpayer may still be able to claim a deduction (rather than a foreign tax credit) for the non-creditable payment under another Code section. Section 275(a)(4) does not preclude a deduction for amounts that are not considered payments of income tax. However, since the payment is not an amount of tax paid, the taxpayer would need to establish that it was an "ordinary and necessary" expense under § 162.

XIV. SUBPART F NON-TAX ACT DEVELOPMENTS.

A. SIH Partners Case.

1. In *SIH Partners LLP v. Commissioner*, 150 T.C. No. 3, January 18, 2018, the Tax Court held in a Summary Judgment decision that the U.S. shareholder of two controlled foreign corporations ("CFCs") that guaranteed loans to the U.S. must include the CFC's applicable earning under § 956 and Subpart F. The court also held that the Subpart F income inclusions did not qualify as dividend income under § 1(h)(11).
2. It was an undisputed fact in the case that the CFCs guaranteed obligations of a U.S. person and that the U.S. shareholder owned the CFCs' stock. The amount of CFCs' applicable earnings was also stipulated.

3. The taxpayer argued that the § 956 regulations are arbitrary and capricious administrative law and that in the process of promulgating the regulations Treasury failed to engage in reasoned decisionmaking or to provide a reasoned explanation for the agency's actions under the Administrative Procedures Act.
4. The court held that the § 956 regulations are subject to the notice and comment requirements of the Administrative Procedure Act since they are creating new law, rights, or duties. However, the court held that the § 956 regulations did not violate the Administrative Procedure Act. The regulations did not reverse previously settled agency policy and were not promulgated contrary to facts or analysis that supported a different outcome. The court stated that Treasury's actions promulgating the rules for pledges and guaranties reflect at most the implementation of a policy judgment. The administrative record reflects that no substantive alternatives to the final rules were presented for consideration during the rulemaking process. The court held that Treasury did not act arbitrarily or capriciously by failing to address contrary viewpoints or findings of fact.
5. The taxpayer argued that the agency was obligated to weigh and balance factors to promulgate rules consistent with the underlying purposes of § 956. The Tax Court did not agree that an on-the-record consideration of any particular factors is required for rulemaking under § 956(d). The plain text of the statute does not require the agency to engage in a process of balancing or to provide an analysis of its decisionmaking. The statute makes no mention of an effective repatriation standard, and the Tax Court found no grounds for imposing such a standard.
6. The taxpayer argued that Treasury recognized that the regulations are inadequate since they have provided guidance stating that when multiple CFCs guarantee the same obligation the current rules may produce "strange results." The court said the multiple CFC "strange result" situation in the guidance is distinguishable since the income inclusions in the case at hand do not exceed the unpaid principal amount of the guaranteed obligations.
7. The Tax Court stated that a CFC's guaranty clearly benefits the U.S. shareholder, and nothing in the statute or its legislative history suggests that Congress expected Treasury to craft ad hoc exceptions based on some sort of facts-and-circumstances test.
8. The Tax Court upheld the validity of Treas. Reg. § 1.956-2(c)(1) and 1.956-1(e)(2) under the Administrative Procedure Act, and that the substance of the regulations is based on a permissible construction of § 956(d) entitled to deference under *Chevron*.

9. The taxpayer also argued that the CFCs' guaranties had no substantial effect on the ability to receive funds and that the CFCs' earnings had nothing to do with the lending decision.
10. The Tax Court stated that neither § 956(d) nor the regulations inquire into the relative importance that a creditor attaches to a guaranty. The rules make no provision for reducing the § 956 inclusion by reference to the guarantor's financial strength or its relative creditworthiness. The Tax Court noted that if a guaranty by a CFC is unnecessary, then it need not be made; and the application and effects of the regulations under § 956(d) will be avoided.
11. In *Cresteck, Inc. v. Commissioner*, 149 T.C. No. 5 (2017), the taxpayer argued the guaranty had little or no value and was a meaningless gesture. The Tax Court in *Cresteck* stated that neither § 956(d) nor the regulations interpreting it inquire into the relative importance that the creditor attaches to the guaranty, and that there is no support for the taxpayer's no-value and meaningless-gesture contentions. This could be important for taxpayers who may have an interest in the affirmative use of § 956.
12. The taxpayer also argued that the guaranty should be "qualified dividend income" under § 1(h)(11). The Tax Court stated that it has held previously that income inclusions required under §§ 951(a)(1)(B) and 956 do not constitute qualified dividend income under § 1(h)(11). *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd*, 722 F.3d 306 (5th Cir. 2013).
13. The taxpayer argued that the court should distinguish *Rodriguez* as being decided narrowly on its facts and that in this case the deemed or constructive dividends were paid out of the CFCs' earnings and profits, to which § 1(h)(11) may apply.
14. The Tax Court found no merit in the distinctions from *Rodriguez*. When a CFC guarantees a loan, the shareholder or a related party benefits from the use of loan proceeds; but the CFC has not distributed its earnings any more than if it had used the earnings to purchase tangible property. The fact that § 951 in operation treats a CFC's investment in U.S. property as if it were a dividend in no way establishes that the income inclusions required for shareholders thereunder actually are dividends for general purposes of the Code.

XV. FOREIGN CURRENCY NON-TAX ACT DEVELOPMENTS.

A. Proposed Foreign Currency Regulations.

1. Treasury and the IRS proposed regulations that provide guidance on the treatment of foreign currency gain or loss under the business needs exclusion from foreign personal holding company income ("FPHCI"). They also provide an election to use a mark-to-market method of

accounting for foreign currency gain or loss attributable to § 988 transactions.

2. Treasury and the IRS believe that foreign currency gain or loss arising from a transaction or property, or from a bona fide hedging transaction, should be eligible for the business needs exclusion to the extent the transaction or property generates non-Subpart F income.
3. Accordingly, Prop. Treas. Reg. § 1.954-2(g)(2)(ii)(C)(1) provides that foreign currency gain or loss attributable to a transaction or property that gives rise to both Subpart F income and non-Subpart F income is allocated between Subpart F income and non-Subpart F income in the same proportion as the underlying transaction or property.
4. Any foreign currency gain from property that does not qualify for the business needs exclusion is Subpart F income. Any foreign currency gain from a hedge that is not a bona fide hedging transaction is also Subpart F income.
5. Under the proposed regulations a transaction that manages exchange rate risk for a CFC's net investment in a qualified business unit ("QBU") that is not treated as a separate entity for tax purposes will qualify for the business-needs exclusion to the extent the QBU's underlying property doesn't give rise to Subpart F income.
6. Prop. Treas. Reg. § 1.954-2(g)(2)(ii)(C)(2) provides that the qualifying portion of any foreign currency gain or loss that arises from a "financial statement hedging transaction" for a QBU and that is allocable to non-Subpart F income is directly related to the business needs of the CFC.
7. A "financial statement hedging transaction" is defined as a transaction that is entered into by a CFC for the purpose of managing exchange rate risk with respect to part or all of that CFC's net investment in a QBU that is included in the consolidated financial statements of a United States shareholder of the CFC or a corporation that directly or indirectly owns such United States shareholder. The "qualifying portion" is defined as the amount of foreign currency gain or loss arising from a financial statement hedging transaction that is properly account for under U.S. GAAP as a cumulative foreign currency translation adjustment to shareholders' equity.
8. Comments were requested on whether the hedge timing rules should apply to financial statement hedging transactions and on whether the business-needs exclusion should apply to a transaction that is entered into in order to manage the risk of foreign currency fluctuation on a CFC's net investment in a subsidiary CFC. Comments were also requested on the business-needs exclusion for foreign currency gain or loss arising from a

transaction that manages the risk of foreign currency fluctuation for disregarded transactions, including disregarded loans, between a CFC and its QBU.

9. Prop. Treas. Reg. § 1.954-2(a)(4)(ii) revises the definition of a bona fide hedging transaction to permit the acquisition of an interest-bearing debt instrument by a CFC to be treated as a bona fide hedging transaction, provided that the acquisition of the debt instrument has the effect of managing the CFC's exchange rate risk. If a CFC, including a treasury center CFC, identifies a debt instrument that manages exchange rate risk as a hedge of an interest-bearing liability, the foreign currency gain or loss arising from that debt instrument will be taken into account under Treas. Reg. § 1.446-4 at the same time as the foreign currency gain or loss arising from the hedged interest-bearing liability.
10. The proposed regulations also broaden the mark-to-market election. Prop. Treas. Reg. § 1.988-7 permits a CFC to elect to use a mark-to-market method of accounting for § 988 gain or loss, including becoming an obligor under an interest-bearing liability. This elective mark-to-market method of accounting takes into account only changes in the value of the § 988 transaction attributable to exchange rate fluctuations and does not take into account changes in value due to other factors, such as changes in market interest rates or the creditworthiness of the borrower. The election is available to any taxpayer but is particularly relevant to treasury centers. The election applies for the year in which the election is made and all subsequent taxable years unless it is revoked. There is a six year lock up for changing the election.
11. Proposed amendments to Treas. Reg. § 1.954-2(g)(2)(iii) require foreign currency gains and losses arising from a transaction or property (including debt instruments) that manages exchange rate risk with respect to an interest-bearing liability to be allocated and apportioned between Subpart F income and non-Subpart F income in the same manner that foreign currency gain or loss from the interest-bearing liability would be allocated and apportioned.
12. Prop. Treas. Reg. § 1.954-2(g)(3)(iii) permits a CFC to revoke its election under Treas. Reg. § 1.954-2(g)(3) to characterize foreign currency gain or loss that arises from a specific category of Subpart F income as gain or loss in that category at any time without securing the prior consent of the IRS. Similarly, Prop. Treas. Reg. § 1.954-2(g)(4)(iii) permits a CFC to revoke its election under Treas. Reg. § 1.954-2(g)(4) (to treat all foreign currency gain or loss as FPHCI) at any time without securing the prior consent of the IRS. If an election has been revoked under Prop. Treas. Reg. § 1.954-2(g)(3)(iii) or Prop. Treas. Reg. § 1.954-2(g)(4)(iii), a subsequent election cannot be made for six years.

13. The proposed regulations generally apply to tax years ending on or after their finalization date. However, some provisions apply to bona fide hedging transactions entered into on or after the date the regulations are finalized.

B. NYSBA Report on Branch Currency.

1. The NYSBA issued a report on branch currency on Jan. 22, 2018. The NYSBA favors changes that would allow less burdensome rules for determining current QBU taxable income from unrealized § 987 gain or loss. NYSBA suggests a “profit and loss” method or the “earnings only” method. They also recommend a “lookback” loss deferral rule. NYSBA also advocates a change to the existing transition rule to ensure that items of economic gain or loss remain in the U.S. federal income tax base and are not lost.
2. Nearly all of the complexity of the 2016 Regulations arises from the treatment of historic-rate assets. The treatment of historic-rate assets is not consistent with the statutory text and legislative history. Another problem with the treatment of historic-rate assets is that they often drive tax results that are detached from the associated economic results.
3. The NYSBA recommends an alternative “profit and loss” method patterned on the 1991 proposed regulations that allows taxpayers to compute the QBU’s taxable income by reference to the non-tax profit and loss statement of the QBU, backing out only items arising from assets or liabilities that are not part of the § 987 QBU. Thus, to the extent the QBU’s profit and loss statement reflects items from its investment in non-portfolio stock, partnership interests (and liabilities properly associated therewith), these items would need to be removed and taken into account separately by the owner. The owner would then translate the taxable income determined in the functional currency by applying the existing rules for determining exchange rates (the yearly average exchange rate or spot rate).
4. Under the “profit and loss” method, taxable income arising from the QBU’s activities would be determined entirely in the QBU’s functional currency and then translated into dollars. Unrealized § 987 gain or loss would be measured by reference to the owner’s net investment in the QBU. Section 987 gain or loss would be realized and recognized as remittances are made. An elective regime of this type is preferable to the method in the 2016 Regulations because it (i) significantly easier to implement, (ii) more accurately measures the portion of the owner’s income that is attributable to currency fluctuations, and (iii) is far more consistent with the statutory text and legislative history.

5. Other alternative methods are possible including the earnings only approach. Under the earnings only approach taxpayers elect to determine unrealized § 987 gain or loss by reference to the retained earnings of the QBU rather than by reference to the owner's net investment in the QBU. The dollar basis and functional currency equity pools would be increased only for earnings. Remittances would be allocated between earnings and capital. Remittances would trigger realization and recognition of a portion of the unrealized § 987 gain or loss in the same manner as the base approach. Although it is less economically accurate than a net-investment method, it is easier to administer than the approach of the current regulations.
6. If a remittance loss deferral regime is proposed, then the NYSBA recommends that it "overlay" the remittance concept of the regulations. The NYSBA recommends the look-back approach. It is consistent with the treatment of "net negative adjustments" with respect to contingent payment debt instruments.
7. The NYSBA also recommends a transition rule. The 2006 Proposed Regulations proposed two alternative transition rules a – the "deferral" method and the "fresh start" method. Under the deferral method, immediately before the transition date, all QBUs would be deemed to terminate for purposes of measuring unrealized § 987 gain or loss on a QBU-by-QBU basis as of the transition date. The fresh start method, by contrast, was both more straightforward and less economically accurate. The 2016 Regulations made the fresh start rule the exclusive rule. Given the dollar strength many economically experienced losses would be permanently disallowed. A type of permanent disallowance is an undue financial burden and not congressionally authorized. The NYSBA believes that there should be a single transition rule and that it should preserve lifetime taxable income.

C. Branch Currency Regulations.

1. The IRS and Treasury announced in Notice 2018-57 that they will defer the applicability date of the final § 987 regulations and some provisions in the related temporary regulations by another year. Treasury and the IRS said at the time they made changes to make the § 987 regulations more administrable. However, they did not wait for comments. We were doubtful that the regulations were an improvement.
2. Notice 2017-57 previously delayed the applicability date by one year. The regulations will now apply to tax years beginning on or after three years after the first date of the first tax year following December 7, 2016.
3. Section 987 was enacted over 3 decades ago, and the first set of proposed regulations thereunder was issued over 2-1/2 decades ago. That proposed

regulation later was rejected and withdrawn by Treasury and the IRS. A technical advice memo showed their displeasure with those proposed regulations. More recent iterations of § 987 regulations have been very complex, and criticized by many taxpayers as too complicated.

4. Perhaps we're better off without § 987 regulations. Taxpayers have managed to deal with § 987 without regulations for over 30 years already. Every attempt at regulations seems to cause problems.

D. Foreign Currency Hedging.

1. The New York State Bar Association Tax Section submitted a report on proposed regulations under §§ 446, 954, and 988, addressing the application of the foreign personal holding company income rules for transactions that hedge foreign currency risk.
2. Under the § 954 rules, the underlying transaction in a hedging transaction cannot reasonably be expected to give rise to Subpart F income creating a cliff effect problem.
3. Another problem is that the current rules may create unnecessary risks for treasury centers. The activities of a treasury center with related parties are typically not eligible for the regular dealer activities exception or the active financing exception under Subpart F. As a result, the treasury center could recognize Subpart F foreign personal holding company income (FPHCI) even though its long and short positions in each currency economically offset each other.
4. Another concern is the rule that allocates foreign currency gain or loss on interest-bearing liabilities between Subpart F and non-Subpart F is based on the rules for allocating interest expense, however, there is no corresponding rule for gain or loss generated by transactions that are bona fide hedges with respect to interest bearing liabilities.
5. The current rules also do not adequately address hedges of CFCs or of qualified business units ("QBU"), including the related § 987 issues.
6. The NYSBA report stated that because foreign currency hedging is often driven by financial accounting considerations more than by tax objectives, the development of tax rules for hedging activities needs to be considered in the context of the financial accounting standards.
7. The proposed regulations refer to bona fide hedges of a transaction (not transactions) and property (not properties) giving rise to both Subpart F and non-Subpart F income. The NYSBA stated that as a result arguably aggregate hedges are excluded from the definition of bona fide hedges and recommends that the final regulations address aggregate hedges.

8. Another issue identified by the report is who can make the election under Prop. Treas. Reg. § 1.988-7 and whether making the election for one trade or business will affect the ability of another trade or business to choose whether or not to make the election. The NYSBA recommends Treasury and the IRS confirm that the election does not require the consent of the IRS. The NYSBA also recommends flexibility, subject to appropriate constraints to limit the opportunity for cherry picking.
9. The report requests clarification of the allocation rule in the business needs exclusion. They also recommend that the risk management standard, as opposed to the risk reduction standard, be used in applying the business needs exclusion.
10. The NYSBA believes that the business needs exclusion should be broadened to include hedges of a CFC's net investment in a regarded corporate subsidiary and that the business needs exclusion should apply to hedges of disregarded transactions.
11. The report recommends several approaches for determining when gain or loss could be recognized on net investment hedges in a QBU.
12. To clarify that the hedge timing rules take precedence over the straddle rules for bona fide hedging transactions, the report recommends that the definition of a hedging transaction in Treas. Reg. § 1.1221-2(b) conform to the definition of a bona fide hedging transaction.
13. The report recommends that the pro rata approach to Subpart F should be expanded to cover aggregate hedges and not merely hedges of individual positions.
14. The NYSBA also recommends permitting the Treas. Reg. § 1.988-7 election to be made on a trade or business basis to provide flexibility and provides four possibilities relating to the timing of gain or loss on hedges with respect to § 987 QBUs.

XVI. NEW PARTNERSHIP AUDIT RULES.

A. New U.S. Partnership Audit Rules.

1. The Bipartisan Budget Act of 2015 set forth a new centralized partnership audit regime that will go into effect for partnership tax years beginning on and after January 1, 2018. Most joint venture partnerships with corporate partners likely will elect out of the new rules as a matter of practice. Regulations were recently proposed, withdrawn, and re-proposed again (on June 13, 2017) in essentially the same form. A number of important new issues can arise under these rules in a cross-border context.

2. All adjustments and items relating to a partnership are determined at the partnership level under these new rules. Any income tax (and penalties and interest) resulting from an adjustment to items under the new audit regime is assessed and collected at the partnership level. This partnership-level tax responsibility is a radical change from current law.
3. It is possible to elect out of the new rules in certain cases. *See* § 6221. The election out is made each year on a timely filed tax return, and certain other procedural rules must be followed. Partnerships with partners that are disregarded entities, trusts or upper-tier partnerships cannot elect out, according to the proposed regulations. A foreign corporate partner that would be treated like a C corporation if it were a domestic entity does not preclude an election out.
4. Section 6226 also permits certain partnerships to elect out of the rule requiring the partnership to pay an adjustment and to shift the responsibility to the partners.
5. There can be some uncertainty in respect of both the partnership's and a foreign partner's liability if the partnership has not fully withheld tax under § 1446 on the foreign partner's U.S. effectively connected income (ECI). The foreign partner, of course, is liable for U.S. tax on any ECI allocated to it, and the partnership is liable as well to the extent it fails to withhold under § 1446.
6. The new rules add extra layers of complexity to this situation. For example, if the IRS increases the partnership's ECI amount (resulting in under withholding by the partnership in the year under audit) and a partnership makes a § 6226 election, how must both the foreign partner and the partnership take the adjustment into account? How, and on whom, are penalties calculated?
7. The new rules raise other issues as well. They require a partner on its individual return to report items consistent with the partnership's treatment. Penalties can apply if the partner does not make such consistent reporting.
8. Given these issues, electing out of the new regime might be the simplest thing to do provided the partnership can qualify to elect out, which won't be difficult for most international joint ventures.
9. One significant, and potentially dangerous, area involves so-called "de facto" partnerships. The IRS sometimes asserts, often in a cross border situation, that a business arrangement is "in fact" a partnership for U.S. tax purposes even if there is no partnership agreement or a legal entity that is commercially treated as a partnership. The parties, therefore, might not think that they have a partnership. In FSA 1999-1230, for example, the

transaction involved the construction of a paper mill in the U.S. In FSA 200144015 and ILM 200606035 the transactions involved the distribution of products by a U.S. entity for a foreign enterprise.

10. If the IRS asserts that a de facto partnership exists, the election out of the new partnership audit regime would not be available as it requires that the election be made on a timely filed partnership tax return for the year in issue. De facto partnership issues typically arise years after the tax years in issue.
11. IRS examiners are not always successful in making these de facto partnership assertions, as shown in these rulings. However, there can be a number of consequences if partnership treatment is upheld. The U.S. “partner” could be a § 1446 withholding agent. Partnership elections will not have been made. Now we can add to the list consequences under the new centralized partnership audit rules.

B. International Partnership Centralized Audit Rules. On Nov. 29, 2017, Treasury and the IRS proposed regulations addressing how certain international rules operate in the context of the new centralized partnership audit regime, including rules relating to withholding of tax on foreign persons, withholding of tax to enforce reporting on certain foreign accounts, and the treatment of creditable foreign tax expenditures of a partnership.

1. Withholding.

- (a) The provisions addressing withholding consider both Chapter 3 (under §§ 1441 through 1446) and Chapter 4 (FATCA) withholding. Section 1446 requires a partnership to pay withholding tax to the extent that the partnership has effectively connected income that is allocable to a foreign partner, at the highest rate applicable to that partner. Section 1445 imposes withholding requirements on the disposition of a U.S. real property interest by a foreign person and certain related distributions.
- (b) Previously Proposed Treas. Reg. § 301.6221(a)-1(a) (June 2017) provides that all adjustments to items of income, gain, loss, deduction or credit of a partnership, and any partner’s distributive share of those items, are determined and any tax attributable thereto is assessed and collected, at the partnership level under the centralized partnership audit regime. The preamble to the June 2017 proposed regulations explains that those taxes that are not covered by the centralized partnership audit regime include taxes imposed by Chapters 3 and 4. Accordingly, the IRS will continue to examine a partnership’s compliance with its obligations under Chapters 3 and 4 in a proceeding outside of the centralized partnership audit regime.

- (c) One of the examples in the newly proposed “international” partnership regulations presents a case in which the partnership has failed to report on its partnership return an item of income that it received for which it would have had a withholding obligation under Chapters 3 and 4, and the failure to report the item as discovered in an examination of the partnership’s compliance with its obligations under Chapters 3 and 4. Because an adjustment to increase the partnership’s income would be an adjustment of an item of income of the partnership, it would be subject to the centralized partnership audit regime. The example states that, nonetheless, the IRS is not precluded from determining an adjustment to the same item under Chapters 3 and 4 outside of the centralized partnership audit regime.

2. Foreign Tax Credits.

- (a) A partnership is not eligible to claim a foreign tax credit under § 901. Instead, each partner takes into account its distributive shares creditable foreign taxes paid or accrued by the partnership. Under § 702(a)(6) this amount, known as a creditable foreign tax expenditure (“CFTE”) is accounted for as a separately stated item. Similarly, under § 902(c)(7), a partner is treated as owning a proportional share of stock owned by or for the partnership for purposes of computing a deemed-paid foreign tax credit under § 902.
- (b) Given the nature and purpose of the foreign tax credit to mitigate the effects of double taxation and the importance of preventing inappropriate use of the credit, the proposed regulations set forth special procedural rules. For example, because the amount of foreign tax may change as the result of a foreign audit, refund claim, or other dispute-resolution process involving a foreign tax authority, taxpayers are required to notify the IRS if a foreign tax for which a credit is claimed is refunded (in whole or in part), if an accrued tax remains unpaid after two years, or if the amount of taxes paid differs from the amount accrued. *See* § 905(c).
- (c) Any underpayment resulting from a change in the amount of creditable foreign tax paid or accrued is collectable upon notice and demand. Taxpayers also have a special 10-year period of limitations under § 6511(d)(3) for claiming refunds of overpayments attributable to the application of a foreign tax credit.
- (d) Neither the statutory text of the centralized partnership audit regime nor the explanation of that text prepared by the staff of the Joint Committee on Taxation explicitly addresses coordination with the foreign tax credit rules. Treasury and the IRS believe that,

to the maximum extent possible, the long-standing foreign tax credit rules should be preserved while implementing the broader purpose of the centralized audit regime. That is, the centralized partnership audit regime rules should be promulgated to clarify the appropriate interaction of these two regimes.

- (e) Some of these issues are discussed in the preamble and addressed in the proposed regulations, such as the treatment of CFTEs under the imputed underpayment provisions of the centralized partnership audit regime. Additionally, the preamble discusses the application of the foreign tax credit limitation of partners in a partnership subject to the centralized partnership audit regime, certain special procedural foreign tax credit rules (including those under § 905(c)), and the treatment of credits under §§ 902 and 960. Treasury and the IRS request comments both with respect to the items specifically identified and also with respect to any additional issues regarding coordination of the foreign tax credit regime in the new centralized partnership audit regime.
- (f) A partnership reports CFTEs to its partners as separately stated items, allowing each partner to elect a credit under § 901 or a deduction under § 164(a)(3). Under current rules, the partnership is not required to maintain records to report to the IRS whether its partners claimed credits or deductions with respect to their CFTEs or the extent to which any such credits are subject to a partner's foreign tax credit limitation.
- (g) Accordingly, the tax effects of an adjustment to the CFTEs reported by a partnership cannot be determined solely by examining the return and other records of the partnership. Similarly, the partnership lacks the necessary information to determine those tax effects.
- (h) Proposed Treas. Reg. § 301.6225-1(a)(2) provides that for purposes of determining the imputed underpayment, all applicable preferences, restrictions, limitations, and conventions will be taken into account to disallow netting of adjustments as if the adjusted item was originally taken into account in the manner most beneficial to the partners.
- (i) Consistent with this general approach, proposed rules are added for the creditable expenditure grouping, proposed Treas. Reg. § 301.6225-1(d)(2)(iv)(A), relating to the treatment of adjustments of CFTEs made in an administrative proceeding under the centralized partnership audit regime. These CFTE subgrouping rules serve several goals. First, subgrouping prevents netting of CFTEs between partners, or between separate categories with

respect to the same partner, a restriction which is necessary to preserve the application of the category-by-category limitation required under § 904. Second, by subgrouping based on the sharing ratio of the partners in the reviewed year, adjustments that would be allocable to one partner cannot be netted against adjustments to CFTEs that would be allocable to another partner. This is intended to provide greater consistency with the requirement that CFTEs be allocated in accordance with the partners' interests in the partnership under § 704.

- (j) Proposed Treas. Reg. § 301.6225-1(d)(2)(iv) provides that if the amount of CFTEs is decreased on audit, the item is treated as though the partners had reduced their U.S. tax by that amount and, therefore, increase the imputed underpayment by the amount of the CFTE reduction. Conversely, if the amount of CFTEs is increased on audit, the proposed regulations treat the item as though the FTC limitation would prevent use of the increased credit and, therefore, do not reduce the imputed underpayment.
- (k) Treasury and the IRS recognize that the rules proposed in this section may cause the amount of the imputed underpayment to exceed the amount of tax that would have been due if the partnership had accurately reported in the reviewed year. However, because the partners' foreign tax credit posture is neither reflected on the partnership returns nor required to be maintained in the partnership's books and records, the only practical way to maintain the efficacy of the foreign tax credit rules is to assume both that the partners claimed foreign tax credits for all CFTEs originally reported and that the foreign tax credit limitation would prevent any additional CFTEs from being claimed as credits.
- (l) In addition to the amended return modification and § 6226 election, additional types of modification may be appropriate with respect to some CFTEs under § 6225(c)(6) and proposed Treas. Reg. § 301.6225-2(d)(9). For example, not all partners are eligible to look through the partnership for purposes of determining the separate category of their CFTEs. *See* Treas. Reg. § 1.904-5(h). These partners have only passive category CFTEs, regardless of the category of those items at the partnership level. Under these circumstances, a partnership may request a modification under § 6225(c)(6) by providing sufficient evidence that a particular portion of CFTEs would be allocable to a partner or group of partners who cannot look through the partnership to characterize these CFTEs.

- (m) Treasury and the IRS request comments on the application of the netting rules to CFTEs and the related computation of the imputed underpayment.

3. Section 904 FTC Limitation Rules.

- (a) Under the principles of proposed Treas. Reg. § 301.6225-1 (June 2017), an adjustment decreasing the amount of foreign source income would not offset an adjustment increasing the amount of U.S. source income under the netting process. Instead, these items, the foreign source adjustment (which is negative) and the U.S. source adjustment (which is positive), would be in separate subgroups. Assuming no other adjustments, the decrease in foreign source income would be treated as an adjustment that does not result in an imputed underpayment, and the increase in U.S. source income would be treated as a net positive adjustment included in computing the imputed underpayment.
- (b) Without a subgrouping requirement, the netting of U.S. and foreign source items would circumvent the foreign tax credit limitations under § 904 by effectively ignoring the potential impact of changes to foreign source income on foreign tax credits.
- (c) One obstacle to subgrouping foreign source and U.S. source items is that the source (or allocation and apportionment) of certain partnership items is determined only by the partners. In this regard, § 861 and the regulations thereunder provide that deductible expenses, including interest expense and research and development expense, are allocated and apportioned between foreign source income and other income on the basis of partner-level attributes.
- (d) Therefore, these expense items, when allocated and apportioned, affect the partners' net foreign and U.S. source income. Under the previously proposed regulations (June 2017), adjustments to items that may be sourced (or allocated and apportioned) at the partner level will generally be divided into subgroups in accordance with the specific method applicable for sourcing (or allocation and apportionment) of those items in order to avoid netting that would undermine the application of the foreign tax credit limitation rules.
- (e) Treasury and the IRS recognize that subgrouping significant items of expense, such as R&D or interest, may cause imputed underpayments to exceed the tax that would have been owed had all items been treated correctly in the reviewed year. Treasury and the IRS request comments with respect to the grouping and subgrouping of these items.

4. Section 905(c).

- (a) Section 905(c) generally requires the taxpayers to notify the IRS in the event of certain changes to creditable foreign taxes. Neither the statutory text of the centralized tax partnership audit regime, nor the explanation of that text prepared by the staff of the Joint Committee on Taxation, explicitly addresses § 905(c). There is no indication that the new procedures were intended to restrict either the taxpayer's or the government's right to recoup any overpayment or underpayment of U.S. tax resulting from the re-determination required under § 905(c). It is unlikely that Congress would effectuate a change to long-standing principles through generic procedural provisions without any specific discussion of § 905(c) in the statutory text.
- (b) Generally, if a partnership reports CFTEs and has an adjustment described in § 905(c), there are two ways of viewing the adjustment required under § 905(c): it is either an adjustment at the partnership level, which is subject to the centralized partnership audit regime, or it is an adjustment at the partner level, which is subject to the historic application of this provision in the partnership context. Either of these two approaches presents administrative challenges. Therefore Treasury and the IRS request comments addressing coordination and administration of § 905(c) and the centralized partnership audit regime.

5. Sections 902 and 960.

- (a) Under §§ 902 and 960, certain domestic corporations are permitted to claim credits for foreign taxes deemed paid. The centralized audit regime did not specifically address the treatment the foreign tax credits allowed with respect to deemed paid foreign taxes under the centralized partnership audit regime. In order to preserve the IRS' ability to audit foreign tax credits for deemed paid taxes claimed with respect to stock owned through partnerships subjected to centralized audit regime, coordinating rules are necessary. These rules should ensure that all restrictions and limitations on the foreign tax credit allowed under §§ 902 and 960 are given effect with respect to both items giving rise to foreign tax credits and the foreign tax credits themselves.
- (b) The broad scope of the centralized partnership audit regime contemplates that all tax effects, including foreign tax credits for deemed paid taxes, are considered during a centralized partnership audit. However, in the case of §§ 902 and 960, the current rules require the partners, and not the partnership, to maintain and report the relevant information. Therefore, Treasury and the IRS request

comments on whether it would be appropriate to require a partnership, as opposed to the individual partners, to maintain and report the information necessary to compute deemed paid foreign taxes with respect to foreign corporations which the partnership owns.

XVII. TREATIES.

A. Competent Authority Statistics.

1. The IRS released its annual competent authority statistics for 2015. Part 1 presents statistics concerning cases involving the allocation and attribution of business profits, and Part 2 presents statistics under all other treaty articles.
2. During 2015, 193 APMA allocation cases were resolved, an unusually high number. Foreign-initiated cases (171) accounted for nearly 90% of the total, a skewing significantly higher than in the two previous years.
3. Excluding the 5 cases that were withdrawn by the taxpayer, 97% of the remaining 188 APMA cases resulted in full relief. Only 3 cases were resolved with less than full relief, and only 3 resulted in no relief.
4. Of the 171 foreign-initiated APMA cases, the taxpayer withdrew its case in 4, there was no relief in 2, and partial relief in 3. In each of the other 162 cases, full relief resulted. In 25, the foreign country withdrew the adjustment.
5. Of the 22 U.S.-initiated APMA cases, the taxpayer withdrew its case in 1, there was no relief in 1, and in each of the other 20, full relief resulted. In 9, IRS Exam withdrew its adjustment.
6. Processing time for APMA cases increased over previous three years to 27.7 months for U.S.-initiated adjustments and 32.7 months for foreign-initiated adjustments.

XVIII. OTHER NON-TAX ACT DEVELOPMENTS.

A. Withdrawal of § 385 Documentation.

1. The IRS proposed removing the final § 385 regulations. The documentation rules had already been delayed until Jan. 1, 2019. The proposed rules were reviewed by the White House Office of Management and Budget and returned to the Treasury Department on August 28.
2. The final § 385 documentation rules initially applied to interests issued or deemed issued after December 31, 2017. However, in response to the executive order review of significant tax regulations, the § 385 regulations

were identified as imposing an undue financial burden on U.S. taxpayers or adding undue complexity to the federal tax laws. Treasury and the IRS announced a one-year delay in the application of the documentation rules in Notice 2017-36.

3. After considering numerous comments, Treasury and the IRS now propose to remove the documentation rules. They stated that they may subsequently propose a modified version of the rules. If the documentation rules are removed but new documentation regulations are issued later, they stated that they would have a prospective effective date.
4. Treasury and the IRS estimate that removal of the § 385 documentation regulations will reduce compliance costs for taxpayers by \$924 million over the period 2019-2028 (undiscounted nominal total). Treasury and the IRS also stated that the removal reduces tax revenues but they note that the TCJA change to interest deductions under § 163(j) and to a lesser extent, the taxation of certain base eroding payments to related parties (BEAT), was the primary driver affecting the reduction in tax revenue under § 385. These TCJA provisions eliminated most of the benefit the IRS planned to get under § 385.

B. Illinois Tool Works.

1. The Tax Court held in favor of Illinois Tool Works (“ITW”), ___ T.C. ___ (2018), ruling that the loan from the lower-tier controlled foreign corporation (“CFC”) to the upper-tier CFC was a bona fide debt and could not be recharacterized as a dividend. ITW’s lower-tier CFC lent money to the upper-tier CFC, a holding company with no current or accumulated earnings and profits (“E&P”). The upper-tier CFC then distributed the loan proceeds as a nontaxable return of capital.
2. The IRS contended that the loan was actually a dividend and that the distribution by the upper-tier CFC would be taxable as a dividend under § 301(c)(1).
3. In the alternative, the IRS contended that the U.S. shareholder had insufficient basis in the upper-tier CFC to treat the distribution as a return of capital.
4. The Tax Court identified the following main issues: (1) whether the loan should be treated as a bona fide debt; (2) if the loan is bona fide debt, whether it should nevertheless be recharacterized, under one or more judicial anti-tax-avoidance doctrines, as a dividend; and (3) if the loan is not recharacterized as a dividend, whether the domestic parent shareholder had sufficient basis in the upper-tier CFC to treat the entirety of the distribution as a return of capital. The Tax Court resolved all issues in ITW’s favor.

5. The Tax Court stated that the test for genuine debt is to consider it in the context of the overall transaction and whether the taxpayer intended to create a debt with a reasonable expectation of repayment and (if so) whether that intent comports with creating a debtor-creditor relationship.
6. Since an appeal of the ITW case would be in the Seventh Circuit, the Tax Court looked at the eight debt equity factors established in *Busch v. Commissioner*, 728 F.2d 945, 948 (7th Cir. 1984), *aff'g* T.C. Memo. 1983-98, and supplemented that analysis with six factors from *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).
7. The seven factors from *Busch* include: (1) the taxpayer's statement of intent to repay; (2) the extent of the shareholder's control of the corporation; (3) the retained earnings and dividend history of the corporation; (4) the size of the transfer; (5) the presence of conventional indicia of debt, such as a promissory note, collateral, and interest charges; (6) the treatment of advances in corporate records; (7) the history of repayment; and (8) the taxpayer's use of the funds. The supplemental six factors from *Dixie Dairies* include: (9) participation in management as a result of advancing funds; (10) the status of the advances in relation to regular corporate creditors; (11) "thinness" of the capital structure; (12) the risk involved in making the advances; (13) the identity of interest between the creditor and the shareholder; and (14) the ability to obtain loans from outside sources.
8. *Stated Intent to Repay.*
 - (a) The court held that ITW's actions strongly suggest that it intended to create a bona fide debt.
 - (b) Each loan document was reviewed and approved by each CFC's board of directors before it was executed. The notes required payment of interest and interest payments were properly recorded on the books. The notes required the repayment of principal at fixed maturity dates and the loan was repaid in full via cash transfers.
 - (c) ITW refinanced the loan and extended the maturity date for one year. The IRS argued that the refinancing of the loan weights against a finding of genuine indebtedness. The Tax Court held that refinancing casts no doubt on the intent to repay.
 - (d) The IRS argued that the distribution could have been made in other ways, e.g., by "going negative" or by borrowing in the credit markets. The Court did not agree with the logic of this argument. The Court held that the evidence supported an intent to repay the debt.

9. *Extent of Shareholder Control.* Dividend treatment may be indicated where a shareholder has complete control over the corporate accounts. The Court held that although this factor favors dividend treatment, it carries somewhat less weight. In *Busch*, the sole shareholder was an individual who extracted cash for personal purposes. The Tax Court concluded that while this factors favors the IRS equity argument, the factor “weighs somewhat less heavily in the balance.”
10. *Retained Earnings and Dividend History.* If a corporation has substantial earnings over many years but does not pay dividends, then recurring loans to a shareholder may suggest dividend treatment. In *ITW*, the lower-tier CSA had a substantial dividend-paying history. The IRS noted that the lower-tier CFC did not pay any dividends in 2006. However, the Court declined to draw a negative inference from this fact since many corporations do not pay dividends every year.
11. *Size of the Advance.* The Tax Court stated that the size of the advance “factor overlaps with the ability to repay factor.” It found that this factor is neutral or favors *ITW* slightly.
12. *Conventional Indicia of Debt.*
 - (a) This factor considers the existence of formal indicia of debt, such as a promissory note, interest payments, a fixed maturity date, and a right to enforce repayment. Because *ITW* strictly adhered to all loan formalities, the court held that this factor favors *ITW*.
 - (b) The IRS argued that the lower-tier CFC had no practical ability to enforce repayment because the upper-tier CFC had no operating assets and only held stock of the lower-tier CFC. The Tax Court rejected the IRS argument stating that companies often borrow against capital assets, including stock of their subsidiaries and that the IRS “argument confuses the obligation to repay with the source of funds to be used for repayment.” The upper-tier CFC has three possible sources of repayment funds: “earnings from lower-tier operating subsidiaries, capital contributions from its parent, or a third-party refinancing.”
13. *Treatment of Advances in Corporate Records.*
 - (a) Although the loan was shown as a liability on the upper-tier CFC’s Form 5471 and as an asset on lower-tier CFC’s Form 5471, in neither case was it labeled a “loan to or from shareholders.” The court held that this minor discrepancy does not support an inference that the note was disguised dividend.
 - (b) Since the loan was consistently treated as debt on the books, the court stated that this factor favors debt treatment.

14. *Repayment History and Source.*
- (a) The ability to repay principal and interest out of projected cashflow supports debt characterization. The court stated that the upper-tier CFC's cashflow could easily satisfy its debt obligations.
 - (b) The IRS argued that the interest payments were "circular" because they were ultimately funded by dividends from the lower-tier CFC's subsidiaries.
 - (c) The Court did not find this argument persuasive. As a holding company, the upper-tier CFC "projected cashflow would necessarily be expected to derive chiefly from the earnings of its lower-tier operating subsidiaries." The Court noted that if the IRS theory was accepted, it "would appear to make a holding company incapable of incurring genuine intercompany debt" and that "we are aware of no legal support for the theory."
 - (d) The IRS argued that the upper-tier CFC lacked "an independent ability to repay the loan" because the source of funds for repayment would have to come from the lower-tier CFCs operating subsidiaries, ITW, or a third-party borrowing. The Tax Court stated this will always be true for an intermediate holding company, and it does not mean that the upper-tier CFC lacked an ability to repay the loan. The Tax Court found that the repayment history and source factor favors debt treatment.
15. *Use of Advanced Funds.*
- (a) How funds are used may also be relevant if the funds are used to acquire capital assets, the advance is more likely to be characterized as equity.
 - (b) The Court stated it is not clear how the "use of funds" factor should be evaluated since the shareholder-debtor is a corporation, not an individual. The Court concluded that this factor is best regarded as neutral and in any event is not entitled to great weight.
16. *Participation in Management.* The Court said this is not a debt/equity case and states this factor is unhelpful.
17. *Status of Advances Relative to Other Debt.* The IRS argued that the right to repayment on the loan was structurally subordinated to any debt. The Tax Court held that since this type of subordination arises automatically, it has little relevance in assessing whether the parties intended to create genuine indebtedness. Given that the operating subsidiaries had projected substantial free cashflows the court held that structural subordination

would not meaningfully impact the likelihood of repayment and thus this factor supports debt characterization.

18. *Adequacy of Capitalization.* The purpose of examining the borrower's debt-to-equity ratio is to determine whether it is so thinly capitalized as to make questionable its ability to repay. In ITW's case the Tax Court noted that the upper-tier CFC was very far from thinly capitalized and as a result this factor supports debt treatment.
19. *Risk Involved in Making Advances.* In applying the risk factor the court considered whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or risks. If funds are advanced for a risk purpose, then an inference could be made that the parties do not intend for the debt to be repaid. The Tax Court held that the risk factor overlaps the thin capitalization factor and stated that this factor supports debt treatment.
20. *Identity of Interest Between Creditor and Shareholder.* The Court stated that the identity of interest factor has little meaning in the ITW case because ITW "is not a debt/equity case; the advances were made to the shareholder, not by the shareholder." The court regarded the "identity of interest" factor neutral.
21. *Ability to Obtain Outside Loans.*
 - (a) A borrower's ability to secure a third-party loan to refinance the related-party loan similarly supports debt characterization. The Court found that the evidence shows that the upper-tier CFC could easily have borrowed from an outside lender and that an outside lender would have evaluated creditworthiness by considering all of the assets, including the assets of its lower-tier operating subsidiaries.
 - (b) The Tax Court stated that ability to obtain an outside loan factor is not a mechanical test of absolute identity between the related-party advances and open-market credit transactions. Rather, the "objective is to determine whether an unrelated lender would have extended credit on substantially similar economic terms."
22. *Conclusion.*
 - (a) The Court concluded that nine factors favor debt treatment, four seem neutral or unhelpful in the case, and only one factor favors dividend treatment. The Tax Court held that the note consisted bona fide debt.
 - (b) The IRS argued that judicial anti-tax-avoidance doctrines should be used to recharacterize the repatriation transaction as a dividend.

23. *Economic Substance.*

- (a) The Tax Court noted that the economic substance doctrine, as applied by most courts, has objective and subjective components. The Court found both elements of the economic substance doctrine satisfied.
- (b) The economic reality of the transaction is that the lower-tier CFC made a loan, and the upper-tier CFC made a distribution. This pair of transactions, the Tax Court held, “meaningfully changed the parties’ economic positions: [the lower-tier CFC] now had a \$356.8 million asset on its books, [the upper-tier CFC] was obligated to repay \$356.8 million liability with interest, and the [parent shareholder] received a distribution that enabled [it] to pay down its ...indebtedness.” The Court stated that because the transfer of funds “was a loan in substance as well as in form, neither the economic substance doctrine nor the substance-over-form principle can be used to metamorphose the loan into a dividend.” The Court stated that the intercompany nature of the transfers does not mean that the parties’ economic positions did not change.

24. *Step Transaction.*

- (a) Under the step transaction doctrine formal steps in a transaction may be “disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes.”
- (b) The Court held that the step transaction doctrine has no application. The Court stated that “In reality, respondent is not seeking to collapse unnecessary steps, but to recharacterize the first step as a dividend rather than a loan.”
- (c) The Tax Court stated that there are factual differences between *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979), *rev’g and remanding* T.C. Memo. 1977-93, 36 T.C.M. (CH) 417, but that the basic transaction in is the same: A corporation without accrued or current E&P borrowed against its appreciated assets and made a return-of-capital distribution to its parent in anticipation of future profits. The Tax Court stated that *Falkoff* helps ITW much more than it helps the IRS.
- (d) In *Falkoff* the Seventh Circuit unambiguously rejected the application of the step transaction doctrine and noted that the Tax Court also rejected, at least in part, the step transaction approach.

- (e) In sum the Tax Court was unpersuaded by the step transaction doctrine and stated that *Falkoff* rejected application of that doctrine and the facts are similar, in all critical respects, to the facts of *Falkoff*.

25. *Conduit.*

- (a) The IRS also asserted that the upper-tier CFC served no purpose in the repatriation transaction and was a conduit. The Court held that the IRS asserted the conduit theory to reach the same bottom line as the step transaction theory, namely, that the lower-tier CFC in substance paid a dividend directly to the upper-tier CFC's shareholder out of its accumulated E&P.
- (b) The Court rejected the conduit theory for the same reasons it rejected the step transaction theory. The lower-tier CFC could not have paid a dividend directly to the upper-tier CFC parent shareholder because the upper-tier CFC parent shareholder owned no stock of the lower-tier CFC.

26. *Subpart F Avoidance.*

- (a) The IRS also asserted that ITW should not be allowed to repatriate the earnings of its foreign subsidiaries and avoid U.S. income taxation under Subpart F. The court declined the invitation in the absence of a clear statutory directive supporting the position.
- (b) The Tax Court stated that "it must be left to Congress to repair any shortfall" in the statute. The Tax Court noted that on four occasions the Treasury Department proposed changing the law to reduce taxpayers' ability to use leveraged distributions to effect repatriations of foreign earnings and Congress did not enact any of these proposals.
- (c) The Obama Administration proposed one of these changes in the statute to address repatriation through a loan structure, but, as the Court noted, the change in the law was never made. The accompanying Green Book indicated that such a structure worked without a change in the law.

C. Anti-Inversion Regulations.

- 1. The IRS issued final inversion regulations that are effective on July 12, 2018. The final regulations are similar to the temporary 2016 regulations. Some limited changes were made to the ownership percentage exclusion rules and the substantial business activities test. The regulations combined with the TCJA changes and inversion penalties make inversion transactions less appealing.

2. In applying the passive asset rule for purposes of determining the ownership percentage, the Preamble states that the vote component could give rise to administrative complexities and was removed.
3. The Treasury Department and the IRS also determined that the passive assets rule should be modified to take into account the other stock exclusion rules. The final regulations modify the multiplicand so that stock excluded under any of the stock exclusion rules is not taken into account. Treas. Reg. § 1.7874-7(b)(1).
4. The final regulations retain the controversial serial acquisitions of domestic entities rule which excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain domestic entity acquisitions previously completed by the foreign acquiring corporation (or a predecessor) within a 36-month look-back period.
5. The preamble states that the serial acquisition rule does not target a specific transaction, which is interesting. To quote Hamlet “The lady doth protest too much, methinks.”
6. The preamble notes that a comment asserted that the serial acquisition rule exceeds statutory authority and lacks a reasoned explanation, which was also asserted in *Chamber of Commerce of the United States v. Internal Revenue Serv.*, No. 1:16-CV-944-LY (W.D. Tax Sept. 29, 2017), appeal docketed, No. 17-51063 (5th Cir. Dec. 1, 2017). The preamble states that the court invalidated the temporary regulation based on notice and comment procedural defects and not because the regulation exceeded statutory authority.
7. The final regulations make three technical clarifications to the serial acquisition rule in response to comments.
8. First, the determination of foreign acquiring corporation stock attributable to a prior domestic acquisition does not take into account stock of the foreign acquiring corporation deemed under § 1.7874-10(b) or § 7874(c)(4). Treas. Reg. § 1.7874-8(g)(3).
9. Second, the final regulations provide an additional exception to the term prior domestic entity acquisition if they occur within a foreign-partnered group qualifying for the internal group restructuring exception of § 1.7874-1(c)(2). Treas. Reg. § 1.7874-8(g)(4)(ii)(B).
10. Third, the final regulations define a predecessor of a foreign acquiring corporation for purposes of the serial acquisition rule. Treas. Reg. § 1.7874-8(b).

11. The final regulations provide that the third-country rule generally does not apply if the expanded affiliated group (“EAG”) has substantial business activities in the third country. Treas. Reg. § 1.7874-9(d)(4)(ii). The Treasury Department and the IRS decline, however, to provide an additional exception based on a comparison of treaty benefits.
12. Seven clarifications or modifications were made to the non-ordinary course distributions (“NOCD”) rule. What constitutes a distribution in the context of the NOCD rules is important because the NOCD rule disregards certain skinny-down distributions. The seven modifications are generally helpful, but fairly minor.
13. First, the regulations clarify the definition of distribution so that the exclusion does not apply to a distribution to which § 355 applies, regardless of whether in connection with a reorganization described in § 368(a)(1)(D). In addition, the final regulations refine the definition of distribution such that, in the case of a partnership, a distribution does not include a deemed distribution pursuant to § 752(b) to the extent that the transaction giving rise to the deemed distribution does not reduce the partnership’s value.
14. Second, the final regulations modify a special rule that applies when a domestic corporation distributes stock of another domestic corporation pursuant to a transaction described in § 355, and immediately before the distribution, the fair market value of the controlled corporation represents more than 50 percent of the fair market value of the stock of the distributing corporation.
15. Third, the final regulations clarify how the NOCD rule relates to the expanded affiliated group rules of § 7874(c)(2)(A) and § 1.7874-1.
16. Fourth, the final regulations provide guidance regarding how to allocate NOCD stock among the former domestic entity shareholders.
17. Fifth, the final regulations provide guidance when multiple foreign acquiring corporations complete a domestic entity acquisition, as to which stock the NOCD stock is considered comprised.
18. Sixth, the final regulations address how the NOCD rule applies when, pursuant to § 1.7874-2(e), two or more domestic entities are treated as a single domestic entity.
19. Finally, the final regulations confirm that NOCD stock is included in both the numerator and the denominator of the ownership fraction, except to the extent that the stock is treated as held by a member of the EAG and excluded from the numerator or both the numerator and denominator, as applicable, under the EAG rules. Treas. Reg. § 1.7874-1(d)(2).

20. To make identification compliance easier, under the final regulations, only former domestic entity shareholders (or partners) that own, taking into account the applicable attribution rules, at least five percent of the stock of (or a partnership interest in) the domestic entity need be identified under the de minimis exception.
21. The final regulations define a tax resident of a country as a body corporate liable to tax under the laws of the country as a resident eliminating the need to provide specific guidance on when a foreign acquiring corporation is treated as fiscally-transparent. Treas. Reg. § 1.7874-3(d)(11).
22. The final regulations also contain an interesting lengthy discussion on the regulatory planning and the economic analysis review describing, among other things, the need for the final regulations and alternatives. The preamble states that under Executive Order 12866 the regulation has been designated a “significant regulatory action” although not economically significant. The rule was reviewed by the Office of Management and Budget (OMB) and is considered an Executive Order 13771 deregulatory action.

D. Smith Tax Court Case

1. The Tax Court in *Smith v. Commissioner*, 151 T.C. No. 5 (2018), ruled on three important international tax issues surrounding a distribution and a constructive dividend.
2. First, the Tax Court held that a § 962 election does not make a foreign corporation a domestic corporation for purposes of the qualified dividend income rules in § 1(h)(11) and that a dividend paid by the Hong Kong CFC was taxable as ordinary dividend income.
3. The second holding also involves the qualified dividend income rules. The Tax Court held that summary judgment was inappropriate because there was a genuine dispute of material fact concerning the CFC’s residency and whether the Cypriot CFC was a “qualified foreign corporation.”
4. In the third holding, the Court rejected the taxpayer’s § 956 statute of limitations argument and concluded that the taxpayers received a taxable constructive dividend.
5. The taxpayer’s owned controlled foreign corporations (“CFCs”) incorporated in Hong Kong and later in Cyprus through a pair of grantor trusts and an S corporation.
6. On the first issue, the taxpayer’s argued that the distribution from the Hong Kong CFC was made by a “notional” domestic corporation and constituted qualified dividend income based on having made the § 962

election. The Hong Kong CFC was incorporated in Hong Kong and was not a “domestic corporation” and also was not a “qualified foreign corporation” eligible for benefits of a comprehensive income tax treaty because there is no income tax treaty between the United States and Hong Kong.

7. The Court stated that “in essence, petitioners urge that what § 962 pretends to have occurred actually happened.” The Court found “no support for this theory in the statute, the legislative history, the regulations, or judicial precedent.” The Tax Court stated that in drafting § 962 Congress adopted the counterfactual hypothesis that the § 951(a) inclusions were received by a domestic corporation for the sole and limited purpose of enabling beneficial tax treatment under § 962(a). There is nothing in the statutory text to suggest that Congress intended this counterfactual hypothesis to apply for any other purpose, least of all for purposes of § 1(h)(11), which was not enacted until 41 years later.
8. The Tax Court held that by making the § 962 election the taxpayer got what they bargained for: immediate deemed-paid foreign tax credits and a lower current tax rate on the § 951(a) inclusions which caused them to include more gross income than they would otherwise have had to include. Judge Lauber said that “Unfortunately, that is sometimes how the cookie crumbles.”
9. The second issue was the dividend from the Cypriot entity and whether the CFC was a qualified foreign corporation so that the dividend constituted qualified dividend income. While Cyprus has an income tax treaty with the U.S., in order for the Cyprus CFC to be treated as a “qualified foreign corporation” it must have been (1) a resident of Cyprus under the Treaty and (2) its establishment and operation must not have had, “as a principal purpose,” the obtaining of benefits under the Treaty.
10. For purpose of the residency test, the taxpayers contend that under the Act of State doctrine, the residency certificates are binding on the Court and cannot be disturbed. The IRS argued that summary judgment was not appropriate because there was not sufficient evidence to establish that the Act of State doctrine applied or that management and control of the Cyprus CFC was exercised in Cyprus. The Tax Court agreed with the IRS that a material fact existed as to whether the Cyprus CFC satisfied the residency test. The Tax Court did not address the principal purpose test.
11. The third issue was whether the Cyprus CFC’s cancellation of debt constituted a constructive distribution. The taxpayer argued that the IRS was obligated to make any § 956(a) inclusions when it examined the returns and because the period of limitations had now lapsed, the IRS could not make any more § 956(a) inclusions and could not pursue the constructive dividend theory.

12. The Tax Court stated that the taxpayer’s argument missed the mark for several reasons. The § 956 statute does not require that the inclusion be made the first year in which the CFC acquires its investment or that the inclusion be made for any particular year citing *Crestek, Inc. & Subs. v. Commissioner*, 149 T.C. ____, (July 27, 2017). The only relevant limitation in § 956 is that a § 956 inclusion cannot be made more than once for any particular investment by a CFC in United States property. The Tax Court concluded that the entire account receivable balance was constructively distributed and was taxable as a dividend under §§ 301(c)(1) and 316(a).

E. Hewlett Packard.

1. In *Hewlett-Packard Co. et al. v. Commissioner*, ___F.3d ___ (9th Cir. 2017), the Ninth Circuit affirmed that Hewlett-Packard’s investment in a foreign entity was properly characterized as debt, that HP wasn’t entitled to foreign tax credits, and that a capital loss was a nondeductible fee paid for a tax shelter.
2. The Ninth Circuit stated that like other circuits, it uses a multi-factor test to decide whether an instrument is best characterized as debt or equity, but stated “But our test isn’t a bean-counting exercise.” The Court stated that the best way to read Ninth Circuit precedent is that its test is “primarily directed” at determining whether the parties subjectively intended to craft an instrument that is more debt-like or equity-like. On this account, all factors on the list could be described as “evidence of intent.”
3. The court stated that given a barren slate, the test should simply be directed at determining whether an instrument functions more like debt or equity.
4. With this background in place, the court stated it had no difficulty concluding that the Tax Court did not err in finding that HP’s investment should be characterized as debt. While the factors pointed in different directions, the Tax Court did not commit a clear error in considering or weighting them. Thus, HP lost foreign tax credits and a capital loss. The court referred to the investment as a so-called “FTC generator.”

F. US Appeals Chamber of Commerce Case

1. The U.S. government filed a notice of appeal to the Fifth Circuit in *Chamber of Commerce of the United States of America v. IRS*, No. 1:16-cv-00944 (W.D. Tex. 2017), a case that invalidated certain temporary § 7874 anti-inversion regulations for the Service’s failure to comply with the Administrative Procedure Act.
2. The U.S. District Court for the Western District of Texas held that regulations in issue were unlawfully issued without adherence to the

Administrative Procedure Act's ("APA") notice and comment requirements.

XIX. BEPS DEVELOPMENTS AND CbC REPORTING.

A. OECD CbC Handbooks.

1. On September 29, 2017, the OECD published two handbooks on CbC reporting, one on effective tax risk assessment and the other on effective implementation. The handbooks are intended to help tax authorities develop and implement solutions for the collection and handling of CbC Reports and to make effective and appropriate use of the information they contain.
2. The handbook on *effective tax risk assessment* outlines how tax authorities should use the CbC information and the types of tax risk indicators that may be identified using information contained in CbC Reports. The handbook states that CbC Reports can be a very important tool for the detection and identification of transfer pricing risk and other BEPS-related risk when used alongside other information, but also raises cautions about the risk that simplistic and misleading conclusions may be drawn if CbC Reports are used in isolation.
3. The first three chapters of the effective tax rate assessment handbook provide background information. Chapter 1 contains a high level introduction to CbC Reporting and Chapter 2 considers the role of tax risk assessment, including examples of the approaches used in different countries. The handbook states that CbC reports should facilitate improvements in the allocation of limited resources to the areas of greatest risk, while at the same time giving a tax authority an indication of where economic activity has been taxed correctly, reducing the burden on lower-risk taxpayers. CbC information risk assessment tools should be used to select and to de-select taxpayers for further investigation. A risk assessment strategy should combine different tools and take into account different elements to minimize the risk that a higher risk taxpayer is able to avoid detection by putting in place certain elements to disguise a particular risk flag.
4. Chapter 3 includes a description of the information that will be contained in the CbC Report. CbC Reports provide an overview of what is happening throughout the whole MNE group. CbC Report information may not be available, or not easily available, from existing data sources, including tax information. It is to be used to help improve the quality of conversations between tax authorities and MNE groups, as tax officials will be in a better position to understand how activities in their jurisdiction fit into the overall group.

5. Chapter 4 explores the ways in which CbC Report information can be incorporated into a tax authority's tax risk assessment framework. The handbook notes that transfer-pricing risk arises in three broad scenarios. First, where entities engage in recurring transactions with related parties which have the potential to erode a jurisdiction's tax base over time. This risk can involve tax deductible related party payments and intragroup payments that can be hard to value. Second, transfer pricing risk can arise from large or complex one-off transactions, including business restructurings and transfers of key income producing assets. Third, transfer pricing risk may be greater where a group does not have effective tax governance processes in place to control, document and review the pricing of related party transactions on an ongoing basis.
6. CbC Reports contain data that can assist tax authorities in detecting risk indicators arising from recurring transactions and one-off transactions. The third transfer-pricing risk category may be detected using information contained in the master file, local file and other transfer pricing documentation well as the tax authority's knowledge and experience of the group, including its attitude to tax risk.
7. The handbook identifies three comparisons that can be made using CbC information. First, a MNE group's profile in a particular jurisdiction may be compared with that in other jurisdictions, or with the group as a whole. Second, an MNE group's profile in a jurisdiction may be compared with that of a typical MNE group in the same sector. Finally, an MNE group's profile in a jurisdiction can be compared with CbC reporting information for the same jurisdiction in earlier periods.
8. The handbook lists 19 potential tax risk indicators that can be analyzed from the CbC Report information:
 - (1) The footprint of a group in a particular jurisdiction
 - (2) A group's activities in a jurisdiction are limited to those that pose less risk
 - (3) There is a high value or high proportion of related party revenues in a particular jurisdiction
 - (4) The results in a jurisdiction deviate from potential comparables
 - (5) The results in a jurisdiction do not reflect market trends
 - (6) There are jurisdictions with significant profits but little substantial activity
 - (7) There are jurisdictions with significant profits but low levels of tax accrued

- (8) There are jurisdictions with significant activities but low levels of profit (or losses)
 - (9) A group has activities in jurisdictions that pose a BEPS risk
 - (10) A group has mobile activities located in jurisdictions where the group pays a lower rate or level of tax
 - (11) There have been changes in a group's structure, including the location of assets
 - (12) Intellectual property (IP) is separated from related activities within a group
 - (13) A group has marketing entities located in jurisdictions outside its key markets
 - (14) A group has procurement entities located in jurisdictions outside its key manufacturing locations
 - (15) Income tax paid is consistently lower than income tax accrued
 - (16) A group includes dual resident entities
 - (17) A group includes entities with no tax residence
 - (18) A group discloses stateless revenues in Table 1
 - (19) Information in a group's CbC Report does not correspond with information previously provided by a constituent entity
9. None of these potential indicators should be taken by themselves to suggest that a group poses an increased tax risk in a jurisdiction, but they may be combined in different ways to build an overall picture of the level of tax risk posed by a group.
 10. A summary of the 19 potential tax risk indicators is also included in Annex 2. Annex 2 provides an explanation of what the risk indicator could mean and how else it might be explained. It is important for MNEs to understand and have an explanation for the 19 potential tax risks indicators. For example, a group with a small footprint may have less potential to pose significant tax risk.
 11. However, a low footprint in a CbC Report could be misleading if the activities in a particular jurisdiction are more significant. The handbook states the tax authorities should corroborate this CbC information against other information.

12. Another risk factor is if the results in a jurisdiction deviate from potential comparables, the differences between a jurisdiction and the chosen comparable could be driven by BEPS. However, the difference could be because the chosen comparable is unreliable, or there may be commercial factors to explain any difference.
13. Another risk factor is if there are jurisdictions with significant profits but little substantial activity. This risk factor indicates that profits may have been shifted away from the jurisdiction where the underlying economic activity is occurring. However, there may be commercial reasons why results in a jurisdiction may seem high relative to the activity measures in a CbC Report (e.g. due to tangible assets being heavily depreciated, or intangible assets that are not disclosed).
14. Chapter 5 outlines various challenges that may be faced by a tax authority in using CbC reports for tax risk assessment, which include: (i) the volume of CbC reporting information to be processed; (ii) the need for systems and training to be developed or revised following the introduction of CbC Reporting; (iii) Issues concerning consistency in CbC reporting information; (iv) the risk that CbC reporting information may be used inappropriately; (v) information on specific entities may be concealed within jurisdiction-level information in Table 1; and (vi) the lack of information on specific transactions undertaken by a group.
15. Future versions of the handbook will include approaches that may be adopted to address these challenges, based on the experience of tax authorities. Chapter 6 sets out some of the other data sources that tax authorities should consider alongside CbC reports.
16. Chapter 7 describes how the results of a tax risk assessment using CbC reports should be used. The handbook stresses that CbC reporting information is a powerful tool for high-level risk assessment, but it can never by itself represent conclusive proof that transfer prices are incorrect or that an MNE group is engaged in BEPS.
17. In the handbook on *effective implementation*, Chapter 1 contains a high-level overview of CbC reporting, including a timeline for the filing and exchange of CbC Reports.
18. Chapter 2 discusses the filing and use of CbC Reports. In particular, this chapter describes the framework that a tax authority should have in place to guard against the inappropriate use of the information in CbC Reports.
19. Chapter 3 explores the elements of the legal framework for the exchange of CbC Reports with reference to the model competent authority agreements included in the Implementation Package.

20. Chapter 4 addresses the elements of an effective operational framework for the filing and exchange of CbC Reports. In implementing CbC Reporting, a jurisdiction must ensure it has in place processes in order to identify entities required to file CbC Reports, receive CbC Reports, check the completeness of CbC Reports and prepare them for exchange, and for imposing sanctions for non-compliance.
21. Chapter 5 discusses the benefits of providing guidance on CbC Reporting and obtaining input from key stakeholders. It also discusses the importance of training. Tax auditors and tax specialists would be appropriate candidates for both awareness and specialist training. As a matter of good governance, it is suggested that auditors/specialists not be given access to CbC Reports until they have completed training.

B. International Compliance Assurance Program (ICAP).

1. The International Compliance Assurance Program (“ICAP”) is a voluntary program that will use CbC Reports and other information to facilitate open and co-operative multilateral engagements between MNE groups and tax administrations, with a view to providing early tax certainty and assurance.
2. The ICAP process is intended to enable MNE groups to talk through their CbC Reports and provide clarity to their cross-border activities. The multilateral risk assessment conducted under ICAP will not cover all of an MNE group’s tax issues but instead initially will focus on those associated with transfer pricing and permanent establishments. However, future ICAP risk assessments may include other material international issues agreed between the group and participating tax administrations, such as hybrid entities, hybrid instruments, and withholding taxes.
3. To the extent a participating tax administration agrees that an issue is covered by ICAP, an assurance letter will be issued setting out its findings. The timeline for ICAP will depend upon a number of factors, but in most cases the period from the initial meeting to the issuance of assurance letters should be within 12 months (although this could be as short as 17 weeks).
4. ICAP is beginning with a pilot, in which eight member tax administrations are participating (Australia, Canada, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States). A number of other members will act as observers to the pilot, participating in discussions on the design and operation of the ICAP process, but will not participate in an MNE group’s risk assessment and will not receive information on the groups involved.

5. The pilot program was officially launched on January 23, 2018, at an orientation event in Washington for participating MNE groups and tax administrations, hosted by the IRS.
6. The OECD has issued an ICAP Pilot Handbook, outlining the scope of the pilot program, the ICAP risk assessment process, and governance related matters concerning the program. According to the Handbook, the program is designed to be a swift and coordinated approach to providing MNE groups willing to engage actively, openly and in a fully transparent manner with increased tax certainty, “while identifying areas requiring further attention.”
7. The Handbook notes that ICAP does not provide an MNE group with legal certainty, as may be achieved for example through an APA, but gives assurance where tax administrations participating in the program consider a risk to be low. According to Jennifer Best, director of treaty and transfer pricing operations at IRS LB&I division, the hope with ICAP is that the program will be a dispute prevention effort by identifying certain flows that can be removed from the audit process.
8. According to the Handbook, the anticipated benefits from ICAP include a fully informed and targeted use of CbC information, an efficient use of resources for tax administrators and MNE groups, a faster and clearer route to multilateral tax certainty, and fewer disputes entering the MAP process.
9. The tax filing periods covered under the pilot generally include 2016 and 2017, with the aim to provide tax assurance to an MNE group with respect to covered risks for the next two succeeding tax filing periods.
10. The Handbook outlines the ICAP risk assessment process, which consists of discrete phases:
 - (a) Provision of documentation package and kick-off meeting (6 weeks)
 - (b) Level 1 risk assessment (8 weeks, plus an additional 4-8 weeks if additional time or additional documentation is needed, plus a further 3 weeks if a risk assurance phase is required)
 - (c) Level 2 risk assessment, if required (approximately 5 months, plus an additional 3 weeks if a risk assurance phase is required)
 - (d) Issuance of outcome letters (3 weeks)
11. At the end of the ICAP risk assessment process, an ICAP outcome letter is to be prepared separately by each covered tax administration, which confirms the results of the ICAP risk assessment with respect to the

covered risks for the covered periods. This could include covered risks that are assured as low or no risk, but can also include a description of outstanding issues and next steps for covered risks that are not assured as no or low risk.

C. Discussion Draft on PE Profit Attribution: 2016.

1. The BEPS report on Action 7 (preventing the artificial avoidance of permanent establishment status) said that additional guidance was necessary regarding how the rules of Article 7 of the OECD Model Treaty would apply to permanent establishments (“PEs”) resulting from changes discussed in the report. There was a need to take into account other parts of the BEPS action plan, in particular those dealing with transfer pricing and the work related to intangibles, risks and capital.
2. The Committee on Fiscal Affairs released a July 2016 discussion draft for public comment and held a consultation in October 2016. It had some serious shortcomings in that it applied the so-called “authorized OECD approach” (“AOA”) to determining PE profits. This is a provision that is not contained in most treaties. It was specifically rejected by a number of OECD and non-OECD countries and in the U.N. Model Tax Convention.¹⁸
3. The OECD published a new discussion draft in July 2017 provides high-level guidance for the attribution of profits to PEs in the circumstances addressed by the BEPS Report on Action 7. In particular, the new discussion draft covers PEs arising from Article 5(5) of the OECD Model Treaty, including examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to PEs created as a result of changes to Article 5(4) of the OECD Model Treaty, and provides an example on the attribution of profits to PEs arising from the anti-fragmentation rule.
4. Attribution of Profits to PEs Resulting from These Changes.
 - (a) Once it is determined that a PE exists under Article 5(5), the rights and obligations resulting from the contracts to which that provision refers should be allocated to the PE. This does not necessarily mean that the entire profits resulting from the performance of these contracts should be attributed to the PE. The determination of the profits attributable to the PE are governed by the rules of Article 7. Under Article 7, the only profits attributable to the PE are those

¹⁸ As discussed in the previous discussion draft, a number of OECD and non-OECD countries expressly stated their intention not to include the 2010 AOA version of Article 7 in their treaties. The widely-rejected AOA mandates that tax authorities use transfer pricing to determine the proper profit allocation to a PE as though it was a separate entity. Concerns of countries in rejecting this approach include the idea that multinational companies could then create royalty and other deductions in their PEs.

that it would have derived if were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise. This principle applies regardless of whether a tax administration adopts the AOA contained in Article 7 of the 2010 version of the multinational tax treaty.

- (b) It is possible that Article 7 and Article 9 (associated enterprises) both applicable (*i.e.*, the intermediary and the non-resident enterprise are associated enterprises) and the functions performed by the intermediary can qualify as a significant people function for the attribution of a specific risk to the PE and as risk control functions for the allocation of a risk under Article 9. In these situations, it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary and attributed to the PE. Otherwise, double income could result.
- (c) The net amount of profits attributable to the PE may be either positive, nil or negative (*i.e.*, a loss). In particular, when the accurate delineation of the transaction in the case indicates that the intermediary is assuming the risks of the transaction of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.

5. Example 1: Commissionaire Structure (Related Intermediary).

- (a) TradeCo, a company resident in Country R, buys and sells widgets. SellCo, a related company resident in Country S, performs marketing and sales activities on behalf of TradeCo in Country S as a commissionaire. SellCo does not own the widgets at any point, nor does it have any entitlement to the amounts paid by the buyers for the widgets. Those amounts belong to TradeCo. SellCo receives a commission.
- (b) Under Article 5(5) of the relevant treaty, TradeCo has a PE in Country S, as SellCo habitually concludes contracts there on behalf of TradeCo for the sale of goods by TradeCo. Under Article 7, the profits attributable to the PE are those that the PE would have derived if it were a separate enterprise performing the activities that SellCo performs on behalf of TradeCo. In this case, states the discussion draft, the profits would equal the amount of TradeCo's revenue from sales of goods to customers in Country S, minus: (1) the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (but "*attributing to such party ownership of the assets of TradeCo related to such*

functions, and assumption of the risks related to such functions”); (2) other expenses, wherever incurred, for the purposes of the PE; and (3) the arm’s length remuneration of SellCo.

- (c) Thus, the example restructures the transactions so that SellCo (or the PE) is treated as operating as a buy/sell subsidiary with the buy/sell profits in excess of the commissionaire commission constituting income of the PE.
- (d) This approach raises important legal issues. Where does the tax administrator in Country S, SellCo’s country, get the authority to restructure the TradeCo-SellCo transactions? As the Silicon Valley Tax Director’s Group pointed out in submitting comments on the High-Value-Intangibles discussion draft (below), the OECD Model Tax Convention, Art. 9, provides no authority for recharacterizing an associated-enterprise transaction. We believe that neither does Art. 7, as discussed below.
- (e) The example not only restructures the parties’ transactions, but equally importantly, it also moves assets and income producing functions and activities owned and performed by TradeCo in Country R and treats them as though they were hypothetically owned and performed by a PE in Country S. Where is the authority that supports changing the taxpayer’s actual facts? These functions are performed in Country R and the income from the functions is rightfully taxed by the Country R tax authorities.
- (f) The discussion draft, referring to OECD Model Tax Treaty, correctly states that “the profits to be attributed to the [PE] in accordance with Article 7 are only those that the [PE] would have derived if it were a separate and independent enterprise performing the activities that the dependent agent [SellCo] performs on behalf of [TradeCo].” However, those functions and activities are already fully compensated to SellCo and the related income is already reported by SellCo and taxed by Country S.
- (g) The example, however, then moves functions from TradeCo to the PE. It states that the hypothetical third party in Country S (the PE) is treated as owning “the assets of TradeCo related to such functions, and [having assumed] the risks related to such functions.” But those assets (presumably including at least the relevant accounts receivable and inventory) don’t belong to that hypothetical third party. They belong to TradeCo in Country R, and TradeCo has the risks regarding those assets.
- (h) Obviously, the writers of the discussion draft faced a dilemma: either this bright, shiny new PE in Country S would have no

profits, which is what the OECD Model Treaty would direct and what the countries agreed to in treaty negotiations, or they had to craft a new rule that restructures transactions and moves assets and risk from one country to another to invent/create income in the PE. However, this violates the language in the OECD's Model Income Tax Convention.

- (i) In crafting this new rule, the discussion draft's footnote 6 says that this is "conceptually equivalent to the amount paid by the PE for the inventory 'purchased' from TradeCo. This would correspond to a 'dealing' under the AOA." Reliance on the AOA was a problem with the OECD's last PE discussion draft. Moreover, the new discussion draft seemingly purports to be discussing rules that would apply "regardless of whether a tax administration adopts the [AOA] contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to [PEs]..."
- (j) Yet the discussion draft's writers needed the AOA, with an additional "conceptual" stretch, as the basic unpinning for the proposed new PE profit attribution rules in order to move assets and taxable income into the PE.
- (k) Moreover, if this were the rule, as the discussion draft proposes, TradeCo's taxable income in Country R would need to be reduced by the migration of its assets and risks from its home country to Country S. Perhaps as an affirmative planning matter it could report on its Country R tax returns less taxable income, asserting that it has a PE in Country S and that its assets and risks must be removed from Country R and imported to Country S. The Country R tax authorities presumably would not be pleased with this shift in income out of Country R contrary to Country R's treaty with Country S. Nonetheless, this could create interesting tax-shelter planning opportunities.
- (l) As an alternative, TradeCo could assert that under a full application of AOA principles, it must charge a royalty to the PE in Country S, and that at arm's length, it needs to bill the PE for a required service charge and allocate home-office Country R overhead to the PE. Country S might not get much extra profit in the PE to tax, after all.

6. Example 2: Sale of Advertising on a Website (Related Intermediary).

- (a) SiteCo, a company resident in Country R, owns the rights in a website. SellCo, an associated company resident in Country S, performs marketing activities on behalf of SiteCo in Country S

under a services agreement with SiteCo that provides for the fee payable to SellCo to be equal to a percentage of the sales revenue received by SiteCo from sales of advertising space to customers in Country S. The effect of the arrangement is that SellCo habitually plays the principal role leading to the routine conclusion of sales by SiteCo in Country R to customers in Country S.

- (b) Under Article 7, the profits attributable to the PE would equal the amount of SiteCo's revenue from sales to customers in Country S minus: (1) the amount that SiteCo would have received if had it sold the rights to advertising space to an unrelated party (again restructuring the actual transactions) performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (and again attributing to the PE the assets related to these functions, and the assumption of risks related to the functions); (2) other expenses, wherever incurred, for purposes of the PE; and (3) the arm's length remuneration of SellCo.

7. Example 3: Procurement of Goods (Related Intermediary).

- (a) TradeCo, a company resident in Country R, has as its core business the procurement and sale of widgets. BuyCo, a related company resident in Country S, performs procurement activities on behalf of TradeCo in Country S, purchasing widgets as agent on behalf of TradeCo, and in the name of TradeCo, from unrelated suppliers in Country S. BuyCo does not own the widgets at any point, nor does it have any entitlement to the amounts paid by TradeCo's customers for the widgets procured by BuyCo. Those amounts belong to TradeCo.
- (b) Under Article 5(5), TradeCo has a PE in Country S as BuyCo habitually concludes contracts there on behalf of TradeCo. BuyCo does not do so as an independent agent, and the procurement of widgets for resale is not an activity of a preparatory or auxiliary character in relation to TradeCo's business. Thus, the "preparatory purchasing" PE exception will not apply.
- (c) In this case, the profits of the PE would equal the amount that TradeCo would have had to pay if had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to that supplier ownership of the assets of TradeCo related to these functions, and assuming the risks related to those functions) minus: (1) the amounts paid by TradeCo to unrelated suppliers in Country S; (2) other expenses, wherever incurred, for the purposes of the PE; and (3) the arm's length remuneration of BuyCo. Here, too,

the transaction is recharacterized as though it were a buy/sell transaction involving BuyCo, with the excess profits treated as earned by the PE.

- (d) The U.S. disagreed with the BEPS changes regarding the “preparatory and auxiliary” provisions of treaties on the grounds that the change was too subjective. Thus, the U.S. will not adopt in its treaties the limitation on the stated exceptions from PE status that each must be of a “preparatory and auxiliary” character. Accordingly, a different conclusion could be reached under Example 3 if a U.S. treaty were involved.

8. Example 4: Fragmentation of Activities.

- (a) Example 4 involves warehousing, delivering, merchandising and information collection activities. OnlineCo is a company resident in Country R that sells goods through an online platform directly to customers in various markets including Country S. The goods are purchased from unrelated suppliers. OnlineCo operates a warehouse in Country S which is staffed by 25 employees of OnlineCo. OnlineCo leases the warehouse from an unrelated owner. The employees handle the receipt of shipments from suppliers, the stocking of the goods, and the execution of the deliveries of customers in Country S, using independent delivery providers.
- (b) OnlineCo also has an office in Country S that is located in a different place from the warehouse. The office is staffed by 15 people who are responsible for the merchandising function of OnlineCo’s products and the collection of information from OnlineCo’s customers in Country S.
- (c) Provided that the business activities carried on by OnlineCo at the warehouse and at the office constitute complementary functions that are part of a cohesive business operation, the warehouse and the office constitute two PEs in Country S, as each of these locations is a fixed place of business through which the business of OnlineCo is partly carried on, and the overall activity resulting from the combination of the activities carried on in Country S is not of a preparatory or auxiliary character.
- (d) The profits attributable to the warehouse PE of OnlineCo are those that the PE would have derived if it were a separate an independent enterprise performing the same storage and delivery activities. In this case, the profits would equal the amount that OnlineCo would have had to pay if it had obtained the storage and delivery services from an independent enterprise in Country S minus (attributing to

the service provider ownership of the assets of OnlineCo related to these functions, and assumptions of the risk of OnlineCo related thereto) minus; (1) the employees' compensation paid in Country S; (2) the amounts paid to unrelated service providers in Country S such as the delivery service companies; (3) the amount of the rent paid to the warehouse owner and other expenses related to the maintenance and operation of the warehouse; and (4) any other expenses wherever incurred, for purposes of the PE.

(e) The profits attributable to the office PE of OnlineCo are those that the PE would have derived if it were a separate and independent enterprise performing the merchandising and collection of information services. In this case, the profits would equal the amount that OnlineCo would have had to pay if it had obtained the same merchandise and collection of information services from an independent enterprise in Country S (attributing to the service provider ownership of the assets of OnlineCo related to that function, and assumption of the risks of OnlineCo related to that function) minus (1) the employees' compensation paid in Country S; and (2) any other expenses, wherever incurred, for the purposes of the PE.

(f) This issue, involving multiple PEs in a given country, of course, was the very concern expressed by the Tax Executives Institute when it submitted comments on the "anti-fragmentation" rules. The rules can apply when there are no BEPs concerns and a multinational company is simply trying to operate its business. The U.S. also has expressed concerns regarding profit attribution to multiple PEs.

D. PE Profit Attribution: Additional Guidance: 2018.

1. The OECD released additional guidance on the attribution of profits to a permanent establishment ("PE") under BEPS Action 7 on March 22, 2018. The only substantive change in the additional guidance is that the OECD clarified the application of the authorized OECD approach ("the AOA," as contained in article 7 of the 2010 version of the OECD model).
2. This is a helpful clarification. We expressed our concerns above that the report relied on the AOA, with an additional "conceptual" stretch, as the basic unpinning for the proposed new PE profit attribution rules in order to move assets and taxable income into the PE. We submitted a comment letter to the OECD expressing concerns similar to those expressed in "C" above.
3. The report addresses this AOA issue, but is otherwise largely the same. It contains the same examples. However, the report now states that the

examples are governed by the AOA contained in the 2010 version of Article 7 and that “the attribution of profits to a PE in any particular case will be governed by the applicable tax treaty.” This is helpful.

4. The report states that it should be noted that many tax treaties contain a version of Article 7 that does not require the use of the AOA. In cases governed by those treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might differ significantly from the AOA. This might be a function of the interrelation between the treaty and the domestic law of the jurisdiction where the PE is located (*e.g.*, if the treaty expressly permitted the use of a customary domestic law apportionment approach, and domestic law contained such an approach). In other cases, the treaty might expressly prohibit the recognition of notional dealings between the PE and the non-resident enterprise of which it is a part (*e.g.*, treaties with a version of Article 7 based on the United Nations Model Double Taxation Convention between Developed and Developing Countries). Therefore, the report states that “the examples should not be understood as representing the only appropriate approach to attributing profits to a PE.”

E. OECD Hard-to-Value Intangibles Discussion Draft: 2017.

1. The OECD released a discussion draft on May 23, 2017 addressing hard-to-value intangibles (“HTVI”). It’s entitled “Implementation Guidance on Hard-to-Value Intangibles.” The Final Report on BEPS Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) mandated the development of guidance on the implementation of the approach to pricing HTVI.
2. The HTVI approach is intended to allow tax administrators to use after-the-fact profit information as presumptive evidence about the appropriateness of the parties’ transfer prices which of necessity had to be determined prior to the transaction. The new rules are quite controversial, and would seem to deviate from the arm’s length standard. The major concern is how tax administrators will apply them in practice. The new approach to HTVIs in any event deviates from how unrelated parties in the real world deal with the issue as illustrated in the Tax Executives Institute comment letter discussed below.
3. Before discussing the new HTVI implementation discussion draft, it is helpful to first consider the OECD Transfer Pricing Guidelines’ (TPGs) considerations regarding hard-to-value intangibles. The TPGs, of course, were modified as a result of the BEPS project.
4. The TPGs state that a tax administrator may find it difficult to establish or verify what developments or events might be considered relevant for the pricing of a transaction involving the transfer of intangibles or rights in

intangibles, and the extent to which the occurrences of these developments or events, or the direction they take, might have been foreseeable or reasonably foreseeable at the time the transaction was entered into.

5. In these situations, the TPGs state that *ex post* outcomes can provide a pointer to tax administrators about the arm's length nature of the *ex ante* (before the transaction) pricing arrangement to which the associated enterprises agreed, and the existence of uncertainties at the time of the transaction. If there are differences between the *ex ante* projections and the *ex post* results that are not due to unforeseeable developments or events, the differences could indicate that the pricing arrangement to which the associated enterprises agreed did not adequately take into account the relevant developments or events that could have been expected to affect the value of the intangible and the pricing arrangements adopted.
6. The TPGs state that they contain an approach consistent with the arm's length principle that tax administrators can adopt to ensure that the pricing arrangements used by taxpayers are at arm's length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain hard-to-value intangibles, and in which situations this is not the case.
7. Under this approach, *ex post* evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used *ex ante* in determining the transfer price for the transfer of the intangibles or rights in the intangibles.
8. This presumptive evidence is rebuttable if it can be demonstrated that it does not affect the accurate determination of the arm's length price. This situation should be distinguished from a situation in which hindsight is used by taking *ex post* results for tax assessment purposes without considering whether the information on which the *ex post* results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into.
9. Thus, a tax administrator can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing but the consideration of *ex post* evidence should be based on a determination that the evidence is necessary to assess the reliability of the information on which the *ex ante* pricing was based.
10. Under the TPGs, this approach will not apply to transactions involving the transfer of hard-to-value intangibles when at least one of the following exceptions applies.

- (a) The taxpayer provides: (a) details of the *ex ante* projections used at the time of the transfer to determine the pricing arrangements, including how risks were accounted for in the calculations of determining the price, and the appropriateness of its consideration of reasonably foreseeable events and other risks, and the probability of occurrence; and (b) reliable evidence that any significant difference between the financial projections and actual outcomes is due to unforeseeable developments or events occurring after the determination of the price that could not have been anticipated by the associated enterprises at the time of the transaction or the playing out of the probability of occurrence of foreseeable outcomes and that these probabilities were not significantly overestimated or underestimated at the time of the transaction;
- (b) The transfer of the hard-to-value intangible is covered by a bilateral or multilateral advance pricing agreement in effect for the period in question between the countries of the transferee and transferor.
- (c) Any significant difference between the financial projections and actual outcomes mentioned above does not have the effect of reducing or increasing the compensation for the hard-to-value intangible by more than 20% of the compensation determined at the time of the transaction.
- (d) A commercialization period of five years has passed following the year in which the hard-to-value intangible first generated unrelated party revenues for the transferee and in which commercialization period any significant difference between the financial projections and the actual outcomes was not greater than 20% of the projections for that period.

11. Tax Executives Institute (TEI) submitted comments on an earlier BEPS discussion draft addressing HTVIs that was issued before the TPGs were revised. TEI said that the discussion draft assumed that independent enterprises are able to renegotiate agreements if major unforeseen developments occur. In TEI's experience, however, such renegotiations are extremely rare, and even a "repricing" of some sort or after-the-fact review of contract terms is not common in contracts between unrelated parties. TEI stated that agreements may be structured to minimize the business risks of a "bad deal," such as a shorter contract term, or through the use of a price adjustment or contingent payment mechanism based on meeting certain milestones. Needless to say, however, stated TEI, in contracts between unrelated parties these terms are set at the outset of the contract through negotiations using only before-the-fact information.

12. The new implementation discussion draft regarding “Implementation Guidance” (May 23, 2017) is helpful to the extent it makes it clear that tax administrators are not to base transfer prices and valuations solely on the *ex post* income. Application of these rules in practice will determine the reasonableness of the new rules in the context of the OECD TPGs overriding theme that related parties are supposed to deal at arm’s length.
13. Under the new discussion draft, tax administrators are only supposed to consider *ex post* (after the fact) outcomes as presumptive evidence about the appropriateness of the pricing arrangements if the intangible is a HTVI.
14. While it’s good to see this new “Implementation Guidance” emphasizing the limitations on the use of *ex post* results, as noted above, the concern of many taxpayers is how tax administrators will apply the TPGs dealing with HTVIs. Beauty is in the eye of the beholder, and the concern is that tax administrators will take this new HTVI guidance and start to apply *ex post* outcomes more broadly than the TPGs intend.
15. The term “HTVI” itself defies an objective definition. It reminds us of the famous U.S. Supreme Court case in which a judge said about pornography: “I can’t define it but I know it when I see it.” The issue here is whether tax administrators and the taxpayers will “see” the same thing in trying to determine whether a particular transaction involves an HTVI.
16. The term “HTVI” covers intangibles for which (i) no reliable comparables exist, and (ii) the projections of future profit, or the assumptions used in valuing the intangibles are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. Defining “HTVI” by using subjective terms like “highly uncertain” and “making it difficult” are at the root of the problem, of course.
17. An HTVI *ex post* adjustment cannot be used based on the comparable uncontrolled transaction method (“CUT”), which is a transaction-based method based on at least one or more reliable comparable transactions. HTVI only affects profit-based methods such as the comparable profit method (“CPM”) and the profit-split method.
18. Exemptions from the use of *ex post* adjustments are listed in paragraph 6.193 of the TPGs (numbers 1-4 above). One applies, for example, if the actual profitability *ex post* does not deviate by more than 20 percent of the *ex ante* pricing. The discussion draft states that the measurement of materiality and time periods contained in paragraph 6.193 will be reviewed by 2020.

19. When the actual profit *ex post* is significantly higher than the anticipated profit, then there is presumptive evidence that the projected profit used in the original valuation should have been higher and requires scrutiny, taking into account what was known and could have been anticipated when valuing the profit. However, the valuation cannot be revised without taking into account the probability at the time of the transaction of the profit being achieved.
20. The discussion draft also provides three examples illustrating the application of the HTVI guidance. All three examples are based on a fact pattern where a pharmaceutical company transfers the patent rights to a partially developed Phase III drug compound to a foreign subsidiary (Company S). The *ex ante* price for the drug patent transferred to Company S is determined by the taxpayer to be 700 paid in a lump-sum in the year of the transfer (Year 0) based on an estimation of expected profits over the remaining life of the patent. In determining the valuation, the taxpayer assumed sales would not exceed 1,000 a year, and that commercialization would not commence for six years after the completion of the clinical trials. The examples assume that no reliable comparables exist and that the value is uncertain. Thus, the drug patent is a HTVI. The example also assumes that the exemptions in paragraph 6.193 do not apply unless stated otherwise.
21. In Example 1, Scenario A, the commercialization started during Year 3 since the Phase III clinical trials were completed earlier than projected. The taxpayer could not demonstrate that its original valuation properly took into account the possibility that sales would arise in earlier periods, and also could not demonstrate that such a development was unforeseeable. The example concludes that the tax administrator can use the *ex post* outcome as presumptive evidence that the possibility of earlier sales should have been taken into account in the original valuation. As a result, the taxpayer's original valuation can be revised by the tax administrator to include the three additional years of sales resulting in a revised net present value of the drug in Year 0 to be 1,000 instead of 700. The example states that the arm's length price anticipated should have been 1,000. The guidance is clear the *ex post* approach must be consistent with the arm's length standard. The example makes it clear that the value of 1,000 is not based solely on the actual *ex post* outcome. However, Example 1 does not discuss how the 300 adjustment is calculated.
22. In Example 1, Scenario B, the facts are the same except the additional profits are only 100 instead of 300. Since the *ex post* adjustment is within 20% of the *ex ante* value, the 20% HTVI exemption in paragraph 6.193 applies and the HTVI *ex post* approach does not apply.
23. In Example 2, the sales in Years 5 and 6 are significantly higher than projected. In the original valuation, the taxpayer had not projected sales

higher than 1,000 in any year, but *ex post* outcomes in each of Years 5 and 6 show sales of 1,500. The taxpayer could not demonstrate that its original valuation properly took into account the possibility that sales would reach these higher levels and also could not demonstrate that the higher sales was due to an unforeseeable development. Example 2 concludes that the tax administrator is entitled to make an *ex post* adjustment of 600. Example 2 does not discuss how the 600 adjustment is calculated but states that it is not based solely on the actual *ex post* outcome.

24. The Example also states that the tax administrator may determine that it is consistent with arm's length practices in comparable circumstances to recover the underpayment through an additional lump sum payment of 600 in Year 3 rather than increase the lump sum payment by 600 in Year 0, if that is the common practice in the relevant business sector for the type of intangible.
25. In Example 3, instead of an initial lump sum payment in Year 0, the arrangement is structured as a royalty of 20% on sales. If the initial value should have been 1,300 based on *ex post* evidence resulting in a higher royalty rate, then Example 3 concludes that the amount of the primary adjustment and the corresponding adjustment in open years will be determined in accordance with the domestic law of each country taking into account any applicable statute of limitations.
26. Taxpayers can overcome the presumption of a HTVI *ex post* approach by preparing a robust valuation that considers various possibilities. Taxpayers can also overcome the presumption by demonstrating the variance was due to an unforeseen circumstance. It would be helpful if there were examples demonstrating how the taxpayer could overcome the presumption by proving either (1) the original valuation properly took into account the possibility or (2) that the development was unforeseeable.
27. The discussion draft states that it should be read in conjunction with the Final BEPS Report for Action 14 "Making Dispute Resolution Mechanisms More Effective" and that it is important to permit resolution of cases of double taxation arising from the application of the approach for HTVI through access to the mutual agreement procedure under the applicable treaty.

F. OECD Hard-to-Value Guidance: 2018.

1. The OECD released new final guidance on the application of the approach to hard-to-value intangibles ("HTVI") under BEPS Action 8 on June 21, 2018. Action 8 mandated the development of transfer pricing rules or special measures for HTVI. The outcome of that mandate is found in the 2015 Final Report for Actions 8-10, "Aligning Transfer Pricing Outcomes

with Value Creation” and it was formally incorporated into the Transfer Pricing Guidelines. The BEPS Transfer Pricing Report also mandated the development of guidance for tax administrations on the application of the HTVI approach. Under this mandate, the Committee on Fiscal Affairs issued a public discussion draft in May 2017, inviting comments.

2. The final guidance states that the HTVI approach protects tax administrations from the negative effects of information asymmetry by ensuring that tax administrations can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex-ante* pricing arrangements. The guidance also states that the *ex post* evidence should not be used without considering whether the information on which the *ex post* results are based could or should reasonably have been considered by the associated enterprises at the time the transaction was entered into. The taxpayer can rebut the presumption by demonstrating the reliability of the information supporting the pricing methodology adopted at the time the controlled transaction took place. The basic approach in the final guidance is the same as the public discussion draft.
3. The final guidance aims at reaching a common understanding and practice among tax administrations on how to apply adjustments resulting from the application of the HTVI approach in an effort to improve consistency and reduce the risk of double taxation. It also provides a number of examples and addresses the interaction between the HTVI approach and the access to treaty mutual agreement procedures. The guidance in the recently finalized report was incorporated into the Transfer Pricing Guidelines as an annex to Chapter VI.
4. According to the guidance, state tax administrations should identify and act upon HTVI transactions as early as possible. However, the guidance also notes that some analysis may only be possible some years after the transaction.
5. The guidance added a new footnote in the example section that was not in the discussion draft. The footnote states that the fact that the examples are focused on the pharmaceutical sector should not be interpreted as limiting the application to this particular industry. The HTVI approach can be applicable irrespective of the industry or sector involved.
6. Examples in the discussion draft are included in the new guidance, except that it does not contain previous Example 3. That example provided that if instead of an initial lump sum payment, the arrangement is structured as a royalty, that the amount of the primary adjustment and the corresponding adjustment in open years is determined in accordance with the domestic law of each country, taking into account any applicable statute of limitations. It is unclear why this example was deleted.

7. The drafts person also added a statement that the guidance and examples are not intended to mandate the use of valuation techniques using the discounted value of projected income or cash flows for determining the arm's length price of transactions involving HTVI.
8. The examples also include a new statement explaining that the revised net present value takes into account the functions performed, assets used and risks assumed in relation to the HTVI by each of the parties before the transaction and reasonably anticipated, at the time of the transaction, to be performed, used or assumed by each of the parties after the transaction. This statement is easy to state in an example, but undoubtedly will be more difficult to objectively administer in practice.

G. Digital Economy.

1. The OECD requested input on questions relating to the taxation of the digital economy and sought public feedback by October 13, 2017. A public consultation meeting was held on November 1, 2017 at the University of California, Berkeley.
 - (a) The questions raised by the OECD concern the effect of digitization on business models and value creation, challenges and opportunities for international tax systems, and the implementation of guidance on base erosion and profit shifting. The request for input asked for feedback on the application of several tax policies, including the tax nexus concept of significant economic presence, withholding tax on digital transactions and the digital equalisation levy.
 - (b) The OECD request stated there is a lack of global consensus on how to respond to the tax challenges associated with digitalization. There is a concern that an increasing number of countries have begun taking steps towards the implementation of unilateral and uncoordinated domestic measures such as diverted profits taxes and equalisation levies.
2. The Finance Ministers of ten European Union countries (France, Germany, Italy and Spain, Austria, Greece, Portugal, Bulgaria, Romania and Slovenia) asked the European Commission to explore EU law compatible options based on the concept of an equalisation tax to tax digital companies.
 - (a) On September 21, 2017, the European Commission published a communication to the European Parliament outlining an EU agenda for "A Fair and Efficient Tax System in the European Union for the Digital Single Market." While the European Commission said it would look closely at the OECD interim report

due in early 2018 (discussed below), in the meantime it would continue to evaluate shorter- and longer-term solutions. In a press announcement on the same day, the European Commission said that in the absence of adequate global progress, the EU should implement its own solutions to taxing the profits of digital economy companies.

- (b) The Commission outlined three alternative shorter-term solutions: an equalization tax on the turnover of digitalized companies, a withholding tax on digital transactions, and a levy on revenues generated from providing digital services or advertising activity. These types of taxes would most likely be passed on to consumers. The Commission said that all of the short-term options have pros and cons, and further work is needed on the detailed approach to find a workable solution for the Digital Single Market and the global economy as a whole. The Commission remains convinced that the appropriate level of action is the EU and that only a coordinated EU approach will ensure that the solution is fit for the Digital Single Market and can deliver on the objectives of fairness, competitiveness and sustainability.
- (c) The equalization turnover tax is a tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax. In a corresponding Q&A press release the Commission stated that there is very little detail about the equalization tax so it is impossible to say exactly how it would work in practice until the idea has been properly fleshed out. The Commission believes there are still a lot of questions around what the scope and basis of such a tax might be, for example, how to define digital companies or digital activities. What constitutes “turnover” and how does this vary with different business models? How should such a tax be collected? Questions about the compatibility of this approach with the double-taxation treaties, state aid rules, fundamental freedoms, and international commitments under the free trade agreements and WTO rules would also need to be examined.
- (d) In a Q&A press release, the Commission said political pressure from the European Parliament is growing and that now is the time to take action, which is why the Commission is addressing digital tax now.

- 3. During a September 13 press conference, Pascal Saint-Amans, the OECD’s tax chief, called the EU ministers’ push to tax the digital economy an interesting development. Stephanie Soong Johnston wrote an

excellent article discussion the press conference. Saint-Amans warned against countries taking unilateral actions while the OECD's task force on the digital economy continues its work. Irish Finance Minister Paschal Donohoe said it would be premature for Ireland to act before the OECD completes its analysis of the issue. Ireland is adamantly opposed to the EU moving away from unanimity voting when it comes to approving tax decisions, which would eliminate its veto power on EU tax developments.

4. TEI submitted comments on Jan. 2, 2018, in response to the European Commission's consultation on the digital economy.
 - (a) TEI emphasized that it is neither feasible nor useful to attempt to separate the digital economy from the global economy, given that the entire economy has been digitalized such tax any tax policies that are intended to apply only to the digital sector ultimately would end up applying to the rest of the economy.
 - (b) Further, TEI stated that tax should be imposed where value is created and tax policies should be based on principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality. TEI expressed concerns that the options being considered would violate these principles and discriminate against cross-border business.
 - (c) TEI expressed concerns over proposed temporary solutions, which are both disruptive and also difficult to repeal once in place, thereby hindering rather than facilitating permanent solutions. TEI expressed significant concerns about solutions that apply what is claimed to be an income tax to revenues or gross payments, which would frequently apply in cases in which there is no net income and therefore hinder global growth and create barriers to entry.
 - (d) TEI noted that three of the five long-term solutions (the common consolidated corporate tax base proposal, the EU directive proposal, and the destination-based corporate income tax) would dramatically shift taxing rights to countries in which consumption takes place. This shift would apply to all business engaged in cross-border trade and impact the entire world economy.
 - (e) TEI stated that taxes on turnover could cause significant economic damage, since such levies would target the turnover of digital enterprises without a link to either profits or value creation. Such a tax could not be described as a corporate income tax since it would have no correlation to net income or profits. Equalization taxes and other levies that tax gross turnover and withholding taxes would also pose administrative difficulties.

(f) TEI also stated that the introduction of a significant economic presence threshold would be a significant departure from existing rules, and also would be inconsistent with existing profit attribution rules based on the value of significant people functions located in a country. According to TEI, any changes to the nexus threshold and profit attribution should be addressed collectively as an entire package and agreed upon globally without allowing divergences between countries.

5. Following up on the 2015 BEPS Action 1 Report and in response to a mandate by the G20 Finance Ministers, the OECD issued an interim report on March 16, 2018, with an updated discussion of the taxation of the digital economy. The report is titled, “Tax Challenges Arising from Digitalisation – Interim Report 2018.”

(a) Building on the 2015 BEPS Action 1 Report, the new interim report provides an updated discussion of the changes to the business models and value creation arising from the digital economy, and identifies certain characteristics that are frequently observed in highly digitized business models, and the impact of these characteristics on existing international tax rules.

(b) Chapter 2 of the report discusses the impact of digitalization on business models and value creation, and describes three characteristics that are frequently observed in highly digitalized business models:

i Cross-jurisdictional scale without mass – Digitalization has allowed businesses to locate various stages of their production processes across different countries, and access a greater number of customers around the globe. Digitalization also allows some highly digitalized enterprises to be heavily involved in the economic life of a jurisdiction without any, or any significant, physical presence.

ii Reliance on intangible assets, including IP – Digitalized enterprises are characterized by the growing importance of investment in intangibles, especially IP assets which could either be owned by the business or leased from a third party.

iii Data, user participation, and their synergies with IP – Data, user participation, network effects, and the provision of user-generated content are commonly seen in business models of more highly digitalized businesses. The important role that user participation can play is seen in the

case of social networks, where without data, network effects, and user-generated content, the businesses would not exist.

- (c) Chapter 4 of the report includes a discussion of the uncoordinated and unilateral actions adopted by certain countries that are relevant to the taxation of the digital economy. These actions are grouped into four categories: (i) alternative applications of the PE threshold; (ii) withholding taxes; (iii) turnover taxes; and (iv) specific regimes targeting large MNEs.
- (d) Chapter 5 of the report discusses the implications of the changes arising from digitalization for the international tax system, particularly with respect to existing profit allocation and nexus rules. The report notes the differing views and approaches of participating countries on the question of whether and to what extent the changes arising from digitalization should result in changes to the international tax rules. The report states that these differing perspectives generally fall within three groups:
 - i The first group of countries share the view that certain characteristics frequently seen in highly digitalized business models, in particular the reliance on data and user participation, may lead to misalignments between the location in which profits are taxed and the location in which value is created. The view of this group of countries is that these challenges are confined to certain business models and therefore can be addressed through targeted changes to existing tax rules, rather than a wide-ranging change of the existing international tax framework. These targeted changes would include a reconsideration of the rules relating to profit allocation and nexus.
 - ii The second group takes the view that the ongoing digital transformation of the economy, and more generally trends associated with globalization, present challenges to the continued effectiveness of the existing international tax framework for business profits. These challenges are viewed by this group as not being exclusive or specific to highly digitalized business models. These countries believe that the changing global economy presents a challenge to the adequacy of the two basic concepts that underlie the current tax framework (*i.e.*, profit allocation and nexus).
 - iii The third group of countries considers that the BEPS package has largely addressed the concerns of double non-taxation, although it is still too early to fully assess the

impact of all the BEPS measures. These countries are generally satisfied with the existing tax system and do not currently see the need for any significant reform of the international tax rules.

- (e) Acknowledging that the task of developing, agreeing, and implementing a global, consensus-based solution will take time, the report notes the pressure for some governments to potentially take more immediate action to address the tax challenges presented by the digital economy. Chapter 6 of the report provides a discussion of interim measures that some countries have implemented or plan to implement.
 - i In particular, the report considers an interim measure in the form of an excise tax on the supply of certain e-services that would apply to the gross consideration paid for the supply of such e-services. This proposal was recently introduced by the European (see discussion below).
 - ii The report notes that there is no consensus on the need for, or merits of, interim measures, with a number of countries opposed to such measures on the basis that they will give rise to risks and adverse consequences, including having an adverse impact on innovation and growth, the possibility of over-taxation, and compliance and administration costs.
 - iii Even so, the report includes design considerations identified by countries in favor of introducing interim measures.
- (f) As part of the next phase of work, the participating members have agreed to undertake a coherent and concurrent review of the nexus and profit allocation rules. These two fundamental concepts relate to the allocation of taxing rights between jurisdictions and the determination of the relevant share of the multinational enterprise's profits that will be subject to taxation in a given jurisdiction.
- (g) The report states that an update of this work will be provided in 2019, as members work towards a consensus-based solution and final report by 2020.

6. Immediately following the OECD's issuance of the interim report, U.S. Treasury Secretary Steven Mnuchin issued the following statement in response:

- (a) "The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth.

Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing.”

7. On March 21, 2018, shortly following the OECD’s issuance of its interim report, the European Commission announced two proposals for the taxation of digital businesses.
 - (a) The first EU proposal would create new rules for establishing taxable nexus for companies that are found to have a “significant digital presence.”
 - i The determination of whether a company has a significant digital presence would be based on one of three different user-based criteria: (i) revenues from providing digital services to users in a jurisdiction exceeds €7 million in a tax period; (ii) the number of users of a digital service in a member state exceeds 100,000 in a tax period; or (iii) the number of business contracts for digital services that are concluded in the tax period exceeds 3,000.
 - ii The determination of profits attributable to a significant digital presence would be made following principles under the authorized OECD approach. Thus, a significant digital presence would be attributed the profits that would have been earned if digital presence had been a separate and independent enterprise that was engaged in the same or similar activities under the same or similar conditions, taking into account the assets used, functions performed, and risks assumed. However, this framework would be adapted to reflect the way value is created in digital activities, by taking into account activities undertaken by an enterprise through a digital interface related to data and users, even though no significant people functions are performed in the jurisdiction of the significant digital presence.
 - iii The proposal also recommends that member states amend their double tax treaties with non-EU countries to expand the definition of a PE to include a significant digital presence.
 - (b) The second EU proposal would impose an interim 3% Digital Services Tax (“DST”) on the revenues resulting from the supply of

certain digital services that are characterized by user value creation.

- i The services that would fall within the scope of the DST are those where the participation of a user in a digital activity constitutes an essential input for the business carrying out that activity and which enable that business to obtain revenues therefrom. Such services would include targeted advertising that is based on data concerning users' activities on digital interfaces, and intermediation services that allow users to find other users and to interact with them.
 - ii The DST would apply to companies with annual worldwide revenues in excess of €750 million, and annual taxable digital revenues from within the EU in excess of €50 million.
- (c) Despite repeated assurances from European Commission officials that the EU digital tax proposals are not aimed at U.S. technology companies, it is expected that the EU proposals would have a disproportionate impact on U.S. technology companies.
- (d) Support for the EU digital taxation proposals appears to be waning. When the proposals were first issued, the Ministries of Finance of France, Germany, Italy, Spain, and the U.K. issued a joint political statement in support of the EU proposals. Since then, however, Germany's Finance Minister has questioned the tax proposals (likely due to concerns regarding trade tensions with the U.S.). Further, Ireland, Luxembourg, and the Netherlands have voiced strong opposition against the EU digital tax proposals.

H. TEI Comments on Profits Splits.

1. TEI provided comments on the OECD public discussion draft under BEPS Action 10 regarding *Revised Guidance on Profit Splits* (the "Discussion Draft").
2. In its first general comment, TEI says that the final guidance on profit splits should clearly state that the transfer pricing best method requirement has not been changed. It should be clear that the profit-split guidance is not intended to promote the method to make it more prevalent, but rather to assist in the method's application. TEI continues to view the comparable uncontrolled price (CUP) method as the most reliable way to apply the arm's length standard. The most appropriate method to assess the arm's length nature of transactions should always be used and there

should be no requirement to use the profit-split method as an additional or corroborative method.

3. TEI says that the Discussion Draft appears to imply that it is easier to apply the profit-split method than other transfer pricing methods. TEI recommends that the OECD note in the final guidance that when confronted with complex operational structures and supply chains, applying the profit-split method correctly is at least as problematic as applying another method. In TEI's opinion, the OECD sometimes over-generalizes the advantages of the profit-split method.
4. TEI believes that a greater emphasis should be placed on the need to determine the profits to be split between group entities using a common accounting standard. While most of these variances are timing differences, they can be substantial and result in large differences on a year-over-year basis.
5. The profit-split examples assume that either the entire transactional profit should be split between the parties or, if another method is more appropriate, none of the profit should be split. TEI said that frequently, it is appropriate to first use a one-sided traditional method and then apply the profit-split method to the residual profits. TEI recommends the OECD include a discussion of this frequently-used dual-method approach in final guidance.
6. The phrase "unique and valuable" is often used in the Discussion Draft. TEI asks the OECD to clarify the meaning of this phrase, especially given that the references and descriptions used for the phrase are somewhat inconsistent. For example, in Paragraph 16, the phrase is narrowly defined implying a high threshold for a contribution to be described as unique. However, Example 9 implies a lower threshold. TEI says that nowhere in the Draft is the term "relevant profits" clearly delineated.
7. TEI points out that it is not clear in a number of the examples why the profit-split method is the most appropriate method. TEI strongly recommends the OECD withdraw Example 2 involving tea sales, since it is not clear why the tea sold could not be valued under a traditional transfer-pricing method.

I. Final OECD Profit Split Guidance: 2018.

1. The final OECD profit split guidance expands on how the profit split method should be applied, including determining the relevant profits to be split and appropriate profit splitting factors. Sixteen examples are included in the revised guidance. The prior guidance only had 10 examples. While the final guidance provides six additional examples and more defined terms, overall, more guidance is needed on how the profit

method should be consistently and accurately applied. The method contains subjective determinations which can make it unreliable.

2. The OECD Transfer Pricing Guidelines have included the transactional profit split method since their inception and they have consistently stated that the transactional profit split method is applicable where it is found to be the most appropriate method.
3. The revised guidance clarifies and significantly expands on when a profit split method may be the most appropriate method. The following indicators are relevant:
 - (a) unique and valuable contributions;
 - (b) highly integrated business operation where the contributions cannot be reliably evaluated in isolation;
 - (c) shared assumption of economically significant risks.
4. The guidance reiterates the important fact that a lack of comparables is, by itself, insufficient to warrant the use of the profit split method.
5. The revised guidance adds a new sentence that states that the transactional profit split method is particularly useful when the compensation can be more reliably valued by reference to the relative contributions to the profits than by a more direct estimation of the value of those contributions.
6. New defined terms were added throughout and labeled “Glossary of the Transfer Pricing Guidelines.”
7. “Profit split method” is defined in the Glossary as:

A transactional profit split method that identifies the relevant profits to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate under the principles of Chapter III) and then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm’s length.
8. The revised guidance added a new sentence stating that where there is evidence that independent parties in comparable transactions apply a profit split method among themselves, that evidence should be considered in determining whether the transactional profit split method is the most appropriate method.

9. The term “Unique and valuable contributions” is defined in the Glossary as:

Contributions (for instance functions performed, or assets used or contributed) will be “unique and valuable” in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations.

10. The revised guidance contains a new section stating that when the contributions are highly inter-related or inter-dependent upon each other, the evaluation of the respective contributions may need to be done holistically. A high degree of integration may also affect whether contributions are unique and valuable.

11. “Contribution analysis” is defined in the Glossary as follows:

An analysis used in the profit split method under which the relevant profits from controlled transactions are divided between the associated enterprises based upon the relative value of the contributions made by each of the associated enterprises participating in those transactions, supplemented where possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

12. “Residual analysis” is defined in the Glossary as follows:

An analysis used in the profit split method which divides the relevant profits from the controlled transactions under examination into two categories. In the first category are profits attributable to contributions which can be reliably benchmarked: typically less complex contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable, and/or are attributable to a high level of integration or the shared assumption of economically significant risks. Typically, the allocation of any residual profit (or loss) remaining after allowing for the profits attributable to the first category of contributions would be based on an analysis of the relative value of the

second category of contributions by the parties, supplemented where possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

13. Example 7 is the first of the six new examples. In Example 7, Companies L and M together offer international trade facilitation, freight forwarding and customs broking services to unrelated customers.
14. Companies L and M perform the same services jointly in a highly integrated manner and are highly dependent on each other. They perform similar marketing and customer relationship functions and jointly use a jointly purchased integrated goods-tracking IT system. They each make incremental improvements to the system. The company is valued for its competitive pricing, which is made possible by its efficiency and economies of scale and scope, and seamless integration across international boundaries.
15. Companies L and M jointly perform the same key value-adding functions and jointly use and contribute important assets. Although arm's length pricing for their joint activities is readily available, their operations are highly integrated and interdependent such that it is not possible to use a one-sided method. In this case, the example states that it is likely that a transactional profit split will be the most appropriate method.
16. Example 9
 - (a) Example 9 is the next new example. ACo owns worldwide patents on Compound A and BCo owns worldwide patents on Enzyme B. Both are unique. Each developed their patents by their own efforts, but each were not able to be use their patents as originally intended and neither alone had significant value. Together the patents create a unique and valuable drug. ACo grants BCo the right to use Compound A to develop the new drug and market it.
 - (b) The high level of integration and inter-dependency affects the value and each contribution is unique and valuable in combination. As a result, the transactional profit split method is found to be the most appropriate method.
17. Example 10
 - (a) Example 10 is also new. Company A designs, develops and produces a line of high technology industrial products. A new generation product incorporates a key component entirely developed by Company B. The key component is highly innovative, incorporating unique and valuable intangibles. The success of the new products is heavily dependent upon the

performance of the key component. The key component is specifically tailored for the new products and cannot be used in any other products.

- (b) The accurate delineation of the transaction determines that Company B performs all the control functions and assumed all the risks in relation to the development of the key component and also finds that Company A performs all the control functions and assumed all the risks in relation to the overall production and sale of the new products.
- (c) In this example, it is determined that while each assumes separate economically significant risks, those risks are highly inter-dependent. As a result, it is determined that the transactional profit split method is the most appropriate method.

18. Example 11

- (a) Example 11 is another new example. The success of an electronics product is linked to the innovative technological design of its electronic processes and its major component. The component is designed and manufactured by Company A; and is transferred to Company B which designs and manufactures the rest of the product; and is distributed by Company C.
- (b) The most appropriate method to price the component transferred from A to B may be a CUP, if a sufficiently similar comparable could be found. However, since the component reflects the innovative technological advance which is found to be a unique and valuable contribution it proves impossible (after the appropriate functional and comparability analyses have been carried out) to find a reliable CUP to estimate the correct price.
- (c) Calculating a return on A's manufacturing costs could however provide an estimate of the profit element which would reward A's manufacturing functions, ignoring the profit element attributable to the unique and valuable intangible used therein. A similar calculation could be performed on company B's manufacturing costs. Since B's selling price to C is known and is accepted as an arm's length price, the amount of the residual profit accrued by A and B together can be determined.
- (d) The residual profit may be split based on an analysis of the facts and circumstances that might indicate how the additional reward would have been allocated at arm's length. It is established for the purposes of this example that the relative amounts of R&D expenditure reliably measure the relative value of the companies'

contributions so that, if A's R&D expenditure is 15 and B's 10, the residual could be split 15/25 for A and 10/25 for B.

19. Profit & Loss of A and B

	A	B
Sales	50	100
Less:		
Purchases	(10)	(50)
Manufacturing costs	<u>(15)</u>	<u>(20)</u>
Gross profits	25	30
Less:		
R&D	15	10
Operating expenses	<u>10</u> (25)	<u>10</u> (20)
Net profit	0	10

20. Third-party comparable manufacturers without unique and valuable intangibles earn a return on manufacturing costs (excluding purchases) of 10% (ratio of net profit to the direct and indirect costs of manufacturing). A's manufacturing costs are 15, and so the return on costs would attribute to A a manufacturing profit of 1.5. B's equivalent costs are 20, and so the return on costs would attribute to B a manufacturing profit of 2.0. The residual profit is therefore 6.5, arrived at by deducting from the relevant net profit of 10 the combined manufacturing profit of 3.5.

21. The initial allocation of profit does not recognize the value of their respective unique and valuable contributions. The residual is 6.5 which may be allocated 15/25 to A and 10/25 to B, resulting in a share of 3.9 and 2.6 respectively, as below:

$$\text{A's share } 6.5 \times 15/25 = 3.9$$

$$\text{B's share } 6.5 \times 10/25 = 2.6$$

22. A's net profits would thus become $1.5 + 3.9 = 5.4$. B's net profits would thus become $2.0 + 2.6 = 4.6$.

23. The note section of the example is important. It states that the example is intended to exemplify in a simple manner the mechanisms of a residual profit split and should not be interpreted as providing general guidance as to how the arm's length principle should apply in identifying arm's length comparables and determining an appropriate split. It states that it is important that the principles that it seeks to illustrate are applied in each case taking into account the specific facts and circumstances. In particular, it states that it should be noted that the allocation of the residual profit may need considerable refinement in practice in order to identify and quantify the appropriate basis for the split.

24. The examples also notes that when R&D expenditure is used, differences in the types of R&D conducted may need to be taken into account, e.g.

because different types of R&D may have different levels of risk associated with them, which would lead to different levels of expected returns at arm's length. Relative levels of current R&D expenditure also may not adequately reflect the contribution to the earning of current profits that is attributable to intangible property developed or acquired in the past.

25. The example is extremely simplified. The mechanisms in practice are very subjective. How you account for and measure different types of R&D and different levels of expected returns is complicated and subjective.
26. Example 12
 - (a) Example 12 also is new. A and B undertake the design, manufacturing, marketing and distribution of products and their activities are highly integrated. Company C is responsible for the benchmarkable marketing and distribution to unrelated customers in Country C.
 - (b) Company A and Company B enter into an agreement to buy and sell pieces, moulds and components to manufacture the different products. They have each developed unique and valuable know-how and other intangibles in their respective design and manufacturing processes. Company C does not make any unique and valuable contribution.
 - (c) Design and manufacturing are identified as the key value drivers and the functional analysis shows the economically significant risks are the strategic and operational risks relating to the design and manufacturing functions. Company A and Company B are engaged in a complex web of intragroup transactions where the performance of each company heavily depends on the capacity of the other to provide the different components and other inputs. The manufacturing and design activities of Company A and Company B are highly interdependent and the entities both perform relevant control functions in relation to the economically significant risks. Both Companies A and B make unique and valuable contributions to the manufacturing and design processes.
 - (d) Under these circumstances, the transactional profit split method is likely to be the most appropriate method. However, a one-sided transfer pricing method such as a resale price method or a TNMM is likely to be the most appropriate to determine an arm's length return for Company C.

- (e) Under a residual approach to the transactional profit split method, the first step of the process would be to determine an arm's length return for the less complex, benchmarkable contributions of each of the parties (i.e. Companies A and B). These amounts are then deducted from the pool of relevant profits to identify the residual profits to be split. Under the second step of the residual analysis, the residual profits would then be split between Company A and Company B on the basis of their relative contributions to those residual profits.

27. Example 14

- (a) Example 14 sets forth some illustrations of the effect of choosing different measures of profits.
- (b) In Scenario 1, A and B both manufacture the same widgets and incur expenditure that results in the creation of a unique and valuable intangible which they can mutually use. It is assumed that the contributions are relative to expenditures. The guidance states that it should be noted that this assumption will not always be true in practice. Assuming the residual profit split method is used and the following facts:

	A	B	Combined A + B
Sales	100	300	400
Cost of Goods Sold	60	170	230
Gross Profit	40	130	170
Overhead expenses	3	6	9
Other operating expenses	2	4	6
Expenditure in relation to the unique and valuable intangible	30	40	70
Operating Profit	5	80	85

- (c) Step one is to determine the initial return for the non-unique manufacturing transactions (Costs of Goods Sold + 10% in this example).

A	$60 + (60 * 10\%) = 66$	→ Initial return for the manufacturing transactions of A =	6
B	$170 + (170 * 10\%) = 187$	→ Initial return for the manufacturing transactions of B =	17
		Total profit allocated through initial returns (6+17) =	23

- (d) Step two is to determine the residual profit to be split.
- (e) As shown in the above example, excluding some specific items from the determination of the relevant profits to be split implies that each party remains responsible for its own expenses in relation to it. As a consequence, the decision whether or not to exclude

some specific items must be consistent with the accurate delineation of the transactions.

- (f) Scenario 2 illustrates that in some cases it may be appropriate to back out a category of expenses to the extent that the profit splitting factor(s) used in the residual profit split analysis relies on those expenses. For example, in cases where relative expenditure contributing to the development of a unique and valuable intangible is determined to be the most appropriate profit splitting factor, residual profits can be based on operating profits before that expenditure. After determining the split of residual profits, each associated enterprise then subtracts its own expenditure.
- (g) When the profit splitting factor used to split the residual profit relies on a category of expenses incurred during the period, it is irrelevant whether the residual profit to be split is determined before the expenses are deducted by each party, or whether the residual profit to be split is determined after the expenses are deducted. The outcome can however be different in the case where the splitting factor is based on the accumulated expenditure of the prior as well as current years.

J. Multilateral Instrument

1. Simone Schiavini is a tax lawyer in the transaction tax practice of EY in Milan and an LLM candidate in international tax at Vienna University of Economics and Business. Schiavini wrote a paper entitled “The MLI’s Arbitration Clause: How Many Bilateral Tax Treaties Are Actually Covered?” Schiavini provides an interesting analysis in the context of the new MLI, the so-called Multilateral Instrument.
2. Schiavini notes that as of July 5, 2018, 82 states had signed the MLI, and nine states had ratified it. It is expected to enter into force January 1, 2019. Part VI of the MLI provides provisions for mandatory and binding arbitration for tax authorities to use in international tax disputes if they are unable to reach an agreement using the multi-agreement procedures. The default procedural approach under the MLI is so-called “baseball arbitration,” which calls for the arbitration panel to select one of two proposed resolutions filed by the competent authorities of the two countries involved as a solution to the unagreed issues.
3. Mandatory and binding arbitration is not a minimum standard under the base erosion and profit shifting (BEPS) rules. It applies only at the election of the jurisdictions. According to Article 18 of the MLI, Part VI applies – in place of or in the absence of other arbitration provisions – between two jurisdictions only if they both include the tax treaty with the other jurisdiction in their list of “covered tax agreements” (“CTAs”) and

both jurisdictions notify the OECD depository that they elect to apply Part VI. Thus, Schiavini notes that the actual number of double tax conventions under which disputes will be subject to Part VI depends on the choices made by the signatories.

4. Schiavini states that as of July 5, 2018, 28 states had elected to apply Part VI of the MLI. Only 17 of the 20 states that had committed to implement mandatory binding arbitration under BEPS Action 14 opted for Part VI. Norway and Poland did not opt for Part VI, and the U.S. did not sign the MLI at all. Eleven jurisdictions entered into the MLI and elected to apply Part VI, despite not being among those that originally expressed their commitment to Action 14: Andorra, Barbados, Curacao, Fiji, Finland, Greece, Lichtenstein, Malta, Mauritius, Portugal and Singapore.
5. Article 26, Paragraph 1 of the MLI states that to opt for Part VI the country must identify each CTA that contains an arbitration clause that the MLI will replace, including the relevant article and paragraph. To date, 32 listed and matching CTAs between states opting for arbitration already provide an arbitration procedure. Thus, Schiavini says that Part VI only represents an innovation toward arbitration for 170 CTAs (which seems like a small number given that 28 countries are involved).
6. The coverage of Part VI may also be influenced by the reservations to the scope of arbitration under Article 28 of the MLI. The MLI allows states to exclude specific issues from the scope of Part VI, and it does not place a limit on the extent of these reservations. The acceptance of these reservations is subject to objections from other jurisdictions that opt in to the arbitration provisions. Schiavini states that the objection would have the result that Part VI does not apply to some disputes arising under the CTA between the reserving and objecting states.
7. Schiavini categorizes exclusions from the scope of arbitration. He has 12 categories. The first category is “Cases regarding the application of domestic and treaty anti-avoidance provisions.” The second is “Cases involving tax fraud, criminal offenses, or tax evasion or when series penalties have been imposed.” The third is “Cases in which the disputed income has not been included in the taxable base or is subject to a zero percent rate.” Suffice it to say that there are a number of exclusions that countries have specified.
8. He also notes that Finland, France, Germany, and Spain have excluded cases falling within the scope of the EU arbitration convention and “any other instrument agreed upon by member states.” The EU arbitration convention only applies to cases involving the wrongful application of the arm’s length principle to transactions between associated enterprises of EU member states or to the “internal dealings” of a multinational enterprise established in several member states.

9. Canada and Portugal, in addition to the exclusions noted above, took a different approach and listed the topics that will fall within the scope of Part VI of the MLI – so conversely, all other cases will not be eligible for arbitration.
10. Schiavini states that Japan is the only country that has filed objections, disagreeing with all the reservations on the scope of arbitration made by Australia, Canada, Finland, France, Ireland, Italy and Singapore. Therefore, Part VI of the MLI does not cover CTAs between Japan and those countries.
11. The MLI provides confidentiality obligations for the members of the arbitration panel and others regarding information gathered in the context of the arbitration procedure. Article 23, Paragraph 4 of the MLI allows states to reserve the right to apply an additional confidentiality rule set forth in Article 23, Paragraph 5 of the MLI. The MLI specifically provides a sanction in this article: should the taxpayers or its advisors materially breach the confidentiality obligation, the mutual agreement procedure and the arbitration procedure will terminate for that specific case.
12. The confidentiality obligation applies to CTAs when at least one of the contrasting states has made the appropriate reservation. Article 23, Paragraph 6 of the MLI provides that states that did not opt for the confidentiality obligation under Paragraph 5 may reserve their right not to apply that provision to their CTAs – so that taxpayers and their advisors would be allowed disclose relevant information gathered in the context of the arbitration procedure.
13. Schiavini then discusses the preferences of the 28 states that opted for the MLI regarding the optional confidentiality provisions. He puts them into four groups. Some have not expressed any preferences to confidentiality. Others made the reservation to apply the confidentiality rule. The third category consists of countries that made the reservation that Article 23, Paragraph 7 of the MLI should not apply to CTAs if the other state has made its reservation under Article 23, Paragraph 6 of the MLI. Schiavini’s fourth category specifically refers to Malta which reserved its rights under Article 23, Paragraph 6 of the MLI not to apply the confidentiality rule under Article 23, Paragraph 5. Therefore, (i) Part VI of the MLI will not apply to CTAs between Malta, India, Canada, Finland, Germany and Portugal, and (ii) for the CTAs entered into by Malta and the remaining countries listed under Parts I and II, the optional confidentiality rule will not apply.
14. Schiavini then discusses “choices indirectly affecting coverage.” He uses five categories: (1) “Independent Option versus Baseball Arbitration;” (2) “Relationship with Domestic Remedies;” (3) “Implementation and

Enforcement;” and (4) “Time Period for Referrals;” and (5) “Entry into Force of Part VI.” Schiavini’s paper discusses what choices countries that have opted into Part VI have made with respect to these various optional categories.

15. In his summary, Schiavini derives an “average” arbitration clause for the matching CTAs. He says the “average” arbitration clause will use baseball arbitration procedures, likely will be limited in scope and will not cover cases that deal with domestic anti-abuse provisions or that may trigger criminal sanctions, will apply to cases that are not resolved by a mutual agreement procedure in a three year timeframe, will not cover issues that a national court has already given an opinion about or upon which a national court renders a decision during the arbitration, will include confidentiality obligations for taxpayers and advisors regarding information gathered in the context of the procedure, will include a final decision that will be immediately binding upon the states, and will only take effect for cases submitted to mutual agreement procedure after the MLI enters into force.
16. While the MLI provisions regarding arbitration seem especially complicated, Schiavini’s paper effectively points out how complicated the MLI can be in trying to apply matching provisions to a variety of CTAs.

K. BEPS Financial Transactions.

1. The OECD released a discussion draft on “BEPS’ Actions 8-10: financial transactions” on July 3, 2018, and released comments received on the discussion draft on September 14, 2018. More than 75 commentators responded to the OEC’s draft guidance on intercompany pricing of financial transactions. We will discuss two of these comment letters.
2. Tax Executives Institute (“TEI”) said the discussion draft provides a well-structured overview of the considerations that apply to transfer pricing of intra-group financial transactions. However, TEI also says the generally disjointed nature of and many of the discrete questions included in the draft make it difficult to compose an overarching set of principled comments in reply and, in particular, to draft a coherent executive summary of these comments.
3. TEI nonetheless provided a general executive summary of its primary points:
 - (a) Any OECD guidance on the transfer pricing aspects of financial transactions should be practical and take into account taxpayer compliance costs;
 - (b) The draft could be improved by including guidance on negative interest rates;

- (c) The analysis of recharacterization of a financial instrument as debt or equity, either in whole or in part, is misplaced in the draft and should be removed or significantly modified;
- (d) Accurate delineation of a transaction should start with the contractual terms between the parties and these terms should be respected so long as the parties act consistently with them;
- (e) Business (i.e., non-tax) drivers of the decision to fund the related party with debt or equity, include: flexibility of the funding mix, currency exposure, joint venture requirements, cash extraction, commercial considerations, and matching costs with income;
- (f) Much of the guidance on the determination of a risk-free rate of return, and the allocation of return in excess of a risk-free rate, is inconsistent with the experience of unrelated parties and is likely to cause controversy and practical issues related to allocation of a “residual” return to a party that is not a party to the underlying financial instrument;
- (g) The most efficient way to reward the cash pool members, including the cash pool leader, is to reflect any synergies and other group benefits, as well as the functions performed by the cash pool leader, in the interest rate paid or charged by the cash pool leader;
- (h) TEI believes that a multinational group member would almost always choose to participate in a cash pooling arrangement as compared to options offered by unrelated parties;
- (i) With respect to guarantees, Paragraph 140 states that if a guarantee permits a borrower to borrow a greater amount of debt than accrued in the absence of a guarantee, then, “the remainder of the loan granted should be regarded as effectively a loan to the guarantor followed by an equity contribution by the guarantor to the borrower” describes a recharacterization that is not practicable, is unrealistic and will raise difficult issues in other areas, such as withholding taxes;
- (j) Indicators for recognizing that an insurance policy issuer, including a captive insurer, actually assumes the risks it contractually assumes or whether (i) losses are paid by the captive insurer, or they would be paid if a loss were incurred, whether or not the captive reinsures the risk, (ii) the captive is regulated and audited, and (iii) the licensed and/or regulated fronting insurance carrier is issuing policies in reinsuring with the captive; and
- (k) The approach set forth in Paragraphs 187 and 188, which suggest that captive insurance policies earn a greater return than policies

from unrelated parties, is flawed and is inconsistent with the arm's-length standard and should not be included in the final guidance.

4. The Silicon Valley Tax Directors' Group ("SVTDG"), whose members are a Who's Who of the American High Tech sector, also submitted comments. The SVTDG notes in its introduction that the proposals in the draft do not represent a consensus view of the participants in the OECD process. This is not unexpected, given the complexity of the issues and the discussion.
5. The SVTDG states that in recent years the OECD's transfer pricing guidance has increasingly authorized the use of recharacterization by tax authorities in order to "properly determine an arm's length result" in cases where the authorities believe that a transaction has not been accurately delineated.
6. The SVTDG notes that the draft outlines a number of issues related to financial transactions where the use of recharacterization is suggested, and the SVTDG finds this particularly concerning.
7. Further, the Group notes that the OECD describes and characterizes the corporate treasury function of multinational enterprises in a manner that is inconsistent with the treasury operations of the great majority of its member companies and, it believes, other multinational enterprises. The draft suggests that the treasury function is a support function that provides a routine service that should be compensated as such. The Group states that this is particularly concerning.
8. The SVTDG states that it is common for a corporate treasury to invest in and maintain sophisticated computer systems to implement a large number of financial transactions that take place every month. The treasury will also hold a significant amount of capital required to support and manage the risks and transactions that make up its daily business. The Group proposes that the OECD amend its description and characterization to reflect a potential spectrum of functionality and exposure. The descriptions in the current draft represent the low end of the substances spectrum.
9. It is essential to recognize that it is much more common in multinational enterprises to find treasuries that operate at different points on the spectrum. Examples of the specific responsibilities of the corporate treasury include: analysis and making decisions on the investment of surplus cash, making decisions on the participation of affiliates and cash pools (i.e., setting credit limits), ensuring the pool arrangements are economically efficient for group members, addressing commercial challenges resulting from negative interest rates, managing, netting and bearing foreign currency exchange risks, hedging the net exposure, raising

external financing, making intercompany loans not covered by the cash pool arrangements, providing guarantees, establishing captive insurance arrangements, and establishing and managing commercial relationships with financial institutions on behalf of group companies.

10. The SVTDG states the draft contains a number of proposals that would enhance the discretion allowed to tax administrators to recharacterize debt, and, in particular, would result in the attribution of interest income to deemed lenders. The SVTDG accepts that there may be situations where the debt arrangements may be inconsistent with the arm's length principle. Such cases may arise periodically for commercial reasons, and a tax adjustment or recharacterization in such cases may be a reasonable outcome. However, there is further guidance in the draft that presents recharacterization risks which the SVTDG does not consider reasonable.
11. One example outlined in the draft states that when a lender does not control risks associated with an intercompany loan. The interest received must be bifurcated with the lender entitled to only a risk-free return, while the entity performing the risk control functions receives the remainder of the interest. Another example outlined in Paragraph 140 applies to cases where the effect of a guarantee is to increase the borrowing capacity of the recipient. The guidance suggests that a portion of the loan to the borrower should be recharacterized as a loan to the guarantor, and the same amount is to be recharacterized as an equity contribution from the guarantor to the borrower. The SVTDG is very concerned about the overbroad authorization to recharacterize a loan instrument in the two cases outlined immediately above.

L. Transfer Pricing and Value Creation.

1. Some tax advisors and tax executives have been concerned that under Base Erosion and Profit Shifting ("BEPS") there will be an increased focus on transfer pricing by apportionment instead of an application of the arm's length standard. While it remains to be seen how this will unfold in the future there have been some interesting economic research papers written suggesting that transfer pricing by apportionment by no means will equate to value creation.
2. Mindy Herzfeld discussed four of these papers in an excellent article dated September 3, 2018 titled "Transfer Pricing, and Value Creation." She highlighted that the recent analytical and data-driven work raises questions about whether economic tools can allow policy makers to develop rules that allocate profits based on value creation.
3. Allocating profits based on value creation creates circularity issues. One of the biggest questions inherent in any method that reallocates global profits using formulary apportionment is what factors to use.

4. Three economists Jennifer Bruner, Dylan G. Rassier, and Kim J. Ruhl studied this issue and wrote a paper, “Multinational Profit Shifting and Measures Throughout Economic Accounts,” National Bureau of Economic Research Working Paper No. 24915 (Aug. 2018). In the paper the economists used compensation and sales to unaffiliated parties as the apportionment factors. They concluded that more of the operating profit of U.S. multinationals should be reallocated to the United States to account for the reattribution of operating surplus, earnings and net interest. They say that using separate legal entity accounting to calculate national accounts is questionable.
5. Another group of economists used similar insights into how tax structures influence national account statistics to reassess calculations of productivity growth and concluded that recent productivity growth might be higher than official statistics show (Fatih Guvenen et al., “Offshore Profit Shifting and Domestic Productivity Measurement,” NBER Working Paper No. 23324 (June 2018)). By recalculating official data to account for profit shifting, these economists have determined that some U.S. production has been excluded from official measures.
6. Thomas R. Toslov, Ludvig S. Wier, and Gabriel Zucman (“The Missing Profits of Nations,” NBER Working Paper No. 24701 (Aug. 2018)), analyzed how tax optimization affects the measured GDP, trade balances, and labor and capital share.
7. The economic studies analyzed by Herzfeld all show that economic indicators are greatly distorted because of multinational profit shifting, resulting in artificially low calculations of output, net exports, and profits recorded in non-tax-haven countries.
8. In *GDP: A Brief but Affectionate History* (2014), Diane Coyle illustrated just how poorly conventional economic tools extract meaningful data. According to Coyle, the current economy poses many challenges to outdated calculations of GDP, including measuring innovation and customization. Coyle concludes that because GDP calculations can’t accurately capture the value associated with intangible goods, the wedge between aggregate economic welfare and what GDP measures is growing uncomfortably large.
9. Herzfeld noted that tax rules do not exist in a vacuum and that they must be based on economic concepts and accounting rules. She concluded that quantitative economic analyses and revisionist economic thought demonstrate that there is not necessarily a right economic or accounting answer to profits allocation and that the circularity in the way tax-driven transactional data feed into national account statistics suggest that caution is needed in using existing economic data to formulate both tax and macroeconomic policies.