TAX EXECUTIVES INSTITUTE / SAN JOSE STATE UNIVERSITY
HIGH TECH TAX INSTITUTE

INTERNATIONAL TAX ISSUES AND DEVELOPMENTS

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by

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I. THE INFLATION REDUCTION ACT.

A. Overview.

1. The Inflation Reduction Act (IRA, P.L. 117-169) became law on August 16, when it was signed by President Biden

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

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

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

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

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

3. Adjusted Financial Statement Income.

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

(b) A number of adjustments must be made to the net income or loss on the taxpayer's applicable financial statement to determine adjusted financial statement income. The IRA indicates that appropriate adjustments must be made to adjusted financial statement income when an applicable financial statement period differs from the tax year, but no additional details are provided. If the applicable financial statement is for a group of entities, then rules similar to section

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

4. Further Adjusted Financial Statement

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

II. PTEP PROPOSED REGULATIONS WITHDRAWN.

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

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

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

IV. FINAL SECTION 958 REGULATIONS AND PROPOSED PFIC REGULATIONS.

A. Final Section 958 Regulations.

1. Overview.

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

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

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

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

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

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

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

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

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

(c) A commentator pushed back on the complexity of the pre-finalization applicability and reliance options resulting from requiring numerous unrelated partners to agree and proposed a simpler approach in which consistency would be required only for related partners or at least first tax year beginning on or after January 25, 2022. The preamble states that these inclusions represent subpart F income for two different tax years of the CFC, and therefore there is no duplication or omission of the CFC's subpart F income to the U.S. shareholder partner.

B. Proposed PFIC Regulations.

1. Overview.

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

(b) These changes would result in affected partners needing to diligently monitor when PFIC-related elections — including qualified electing fund elections — need to be made, as these elections would no longer be able to be made by the partnership. As a substantive matter this change makes sense—affected partners will often have differing result, if a domestic partnership or S corporation owns PFIC stock, the excess distribution PFIC rules apply at the partner or S corporation shareholder level.

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

2. <u>QEF Elections</u>.

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

(b) One commentator recommended a transition to an aggregate approach to QEFs with an alternative that would permit a domestic partnership coordinate with the partnership to provide the partner with the necessary information in a timely fashion.

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

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

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

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

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

(i) A grandfathering rule exists for existing QEF elections. QEF elections made by a domestic partnership or S corporation that are effective for tax years of a PFIC ending on or before these regulations are finalized

3. MTM Elections.

(a) For administrability-related reasons similar to those noted for QEFs, some commentators recommended maintaining entity treatment of domestic partnerships under the MTM rules in section 1296. However, Treasury and the

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

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

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

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

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

J. <u>Other Changes</u>.

(a) The term "post-1986 E&P" is the basis upon which a deemed dividend under reg. sections 1.1291-9, 1.1297-3, and 1.1298-3 is determined, and each of those sections generally defines the term by reference to the definition of "undistributed earnings, within the meaning of section 902(c)." However, because section 902 was repealed by the 2017 Tax Cuts and Jobs Act, the proposed regulations revise the definition of post-1986 E&P in reg. sections 1.1291-9(a)(2)(i), 1.1297-3(c)(3)(i)(A), and 1.1298-3(c)(3)(i) to eliminate references to section 902(c) and to define the term by reference to E&P computed in accordance with sections 964(a) and 986.

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

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

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

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

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

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

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

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

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

V. RECENT INTERNATIONAL TAX CASES.

A. Exxon Has Mineral Leases, Not Sales.

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

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

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

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

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

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

B. FTC Source Case.

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

2. Parent (P), a U.S. corporation, claimed an FTC under section 901. In allocating and apportioning interest expense as part of the section 904 limitation calculation, P used the asset method, under which it characterized its CFC stock. However, the CFC appo nshete2o6.5(t)7.1(ho,C)-20..o3(C a)6.5(

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

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

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

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

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

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

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

D. Sixth Circuit's APA Decision.

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

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

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

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

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

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

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

E. Inv(ps007 Tc 0if Tc 0iSect7 Tc 0in 2s45sA Regulatis0s Case

1. A federlstr0 151(c)-14.3(t)7.2(c)6.5(ourt)]TJ 8.313 0 Td ( )Tj [(i)7.2(n Col)7.2(or)-21.2()[8] that the temporlry secti regulations issued in 2019 (T.D. 9865), and retroactive to the appcation of sectiin 245A beginn00-13.7(ng)]TJ 0 scn -0.007 Tc 0.007 as they did noteet the Adm7A-1(i)1521nistrative Procedure Act's notice and comment requirements.

2. This case is important not onhe taxpayers that are affected by the 245A temporlry regulatiins but lo because it provides ldditiinlcase authority that regulatiins, and in particular temporlry regulatiins, must fol the requirements of the APA, inc6.5(l)7A-1(udi)7.2(ng)-20.8(t)7.1(he)6.5(not)7.0.00-13.7(c)6.5(e)6.5(a)6.5(favorable APA cases, including *Mann Constructi*,

[9] affect not ony taxpayers' desi to chaenge regulations and IRS guidance under the APA but lo the IRS's use of temporlry regulatiins and other guidance and the timissuance of regulatiins after Congress enacts a law.

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

4. Liberty Globlc. (LGI) entered into a trlnsactiin 00-13.7(n D)-7.2(e)6.5(c)6.5(e)6.5(m)7.2(U.K. parent company, Liberty Gl LGI was required to recogniz6 under section 245A LGI a 245A to receive the deduc precuded the deductiin, we

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

7. The temporary section 245A regulations had a retroactive effective date to fix the doughnuthts i dadrf-14.4(t)7.2(i)0.2(on 245A)]TJ0 re 4.3(a)t1330o5(nds..5(duh")6.)6.5(r t

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

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

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

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

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

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

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

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

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

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

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

F.

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

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

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

3. Penalty Analysis. .rullAhat the

(a) The court then turned to the penalty issue. Eighteen months after the trial, the IRS asserted penalties of 40 percent under 26 U.S.C. section 6662(h). This occurred after the Tax Court issued its principal opinion (finding that the IRS wrongfully canceled the APAs). Eaton originally argued that the IRS and dete thanked(a)6.5te T( )Tj m (rng t)7.1 2(a)6.5(n)-20.866.5(d penalties question, without adopting the Tax Court's reasoning. The Sixth Circuit ruled in favor of Eaton on the forfeiture claim and did not address the written approval claim.

(c) The Sixth Circuit found that penalties may only be imposed if they are asserted before the hearing or a rehearing in Tax Court under section 6214(a). The Sixth Circuit found that the adjustments that gave rise to the post-trial penalties claim were not placed in issue by the pleadings, addressed as an issue at trial, or discussed by the Tax Court in its prior opinion and, as a result, held that the IRS in the United States and licensed to the Puerto Rican manufacturing subsidiary (MPROC). The IRS rejected Medtronic's CUT method,

(c)

(j) The Tax Court disagreed with the government's argument that

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D. ecton 367(d)TAe Paermtt.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

F. Inversion IRS Ruling.

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

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

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

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

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

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