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U.S. Tax Laws: A Review of 2022 and a Look Ahead to 2023

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As we settle into the new year, let's take a moment to first consider last year's tax developments and then take a look ahead to what 2023 might have in store for us.

Review of U.S. Tax Developments in 2022

In 2022 we finally saw some movement on President Biden's tax policy with the *Inflation Reduction Act* (IRA), which was signed into law on August 16. The IRA introduced a corporate alternative minimum tax based on financial statement income and an excise tax on stock buybacks, and increased Internal Revenue Service (IRS) funding.

In addition, the Treasury Department and the IRS released several important sets of regulations and other guidance on

- the new corporate alternative minimum tax (CAMT)
- the new stock buyback excise tax (Buyback Tax)
- controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs)
- qualified foreign pension funds
- domestically controlled real estate investment trusts (REITs)
- foreign sovereign investment in U.S. real estate

The following discussion reviews developments in U.S. federal tax law in 2022. For previous annual tax law reviews, see our 2022, 2021 and 2020 bulletins.

Legislative and Regulatory Developments

The CAMT

As noted above, the IRA introduced the CAMT, and in December the IRS released a notice describing future proposed regulations on the CAMT. The CAMT is an alternative minimum 15% tax on financial-statement income of corporations with more than $1 billion average financial-statement income over three consecutive years. The tax also applies to a U.S. corporation that is part of a foreign-parented multinational group that meets this income test, if the U.S. corporation has at least $100 million average financial-statement income over the same three-year period. These threshold tests aggregate corporations that are members of the same controlled group (based on 50% ownership) and all trades or businesses under common control, and for purposes of the CAMT, financial statement income is calculated with certain adjustments. These adjustments include taking tax depreciation instead of book depreciation, following the tax result of nonrecognition transactions and income from the cancellation of debt (i.e., not recognizing gain for financial statement purposes and making appropriate adjustments to financial statement basis or attributes), and disregarding financial gain arising on emergence from bankruptcy.

The Congressional Joint Committee on Taxation estimated that only 150 companies will be subject to the CAMT, but it remains uncertain whether the law and regulations could apply the tax to more companies than expected.

The Buyback Tax

Also enacted as part of the IRA, the Buyback Tax is a 1% excise tax on stock buybacks by public corporations. Similar to the CAMT, the IRS released a notice in December describing future proposed regulations that clarify exceptions to the tax but also create additional situations in which the tax could apply with respect to repurchases of stock of public non-U.S. corporations.

The Buyback Tax generally applies to public U.S. corporations and certain inverted public non-U.S. corporations that repurchase stock worth $1 million or more in a tax year. In addition, U.S. affiliates of public non-U.S. corporations would be subject to the tax if they repurchase – or, in some cases, fund a repurchase of – stock of their affiliated public non-U.S. corporation.

Importantly, if regulations are issued as described in the IRS notice mentioned above, any funding (other than by distributions) from a U.S. corporation (or other entity) to a non-U.S. affiliate on or after December 27 could cause the U.S. corporation to be subject to the Buyback Tax with respect to a repurchase by such non-U.S. affiliate of stock of an affiliated public non-U.S. corporation within two years of such funding.

The law and the IRS notice provide several exceptions to the Buyback Tax, including with respect to tax-deferred reorganizations (exempt to the extent gain or loss is not recognized by the shareholder), stock contributed to an employer-sponsored retirement plan, employee stock ownership plan or similar plan, repurchases by a REIT, RIC or dealer in securities in the ordinary course of business, and repurchases treated as dividends for U.S. tax purposes. Notably, the IRS notice creates a presumption against application of the dividend exception and imposes strict requirements to rebut the presumption.

An additional exception applies to liquidating distributions under Section 332(a) and Section 331, but for Section 331, only where all liquidating distributions are made under Section 331. Accordingly, no Buyback Tax would be imposed with respect to liquidating distributions made to a corporation that owns at least 80% of the vote and value of the liquidating company or made by a corporation that does not have an 80% corporate owner.

The implementation of the Buyback Tax appears quite broad and will impact transaction structuring and tax planning for public U.S. and non-U.S. corporations.

CFC and PFIC Regulations

On January 25, 2022, the IRS finalized regulations that look through partnerships so that only partners that are themselves 10% shareholders will have subpart F inclusions from CFCs. On the same day, the IRS issued proposed regulations with respect to PFICs held by partnerships, treating the partnership on a look-through basis with respect to inclusions and elections. This is a departure from current rules, under which, for example, a U.S. partnership would make (or not make) a mark-to-market election or an election to treat a PFIC as a "qualified electing fund." Under the proposed regulations, all PFIC consequences, including inclusions and elections, would be made by the partners instead of the partnership. The proposed regulations also clarify that the "CFC-PFIC overlap rule," which eliminates PFIC status for a 10% shareholder of a controlled foreign corporation, does not apply to a partner of a partnership if the partner itself is not (directly or indirectly) a 10% shareholder. Recognizing the difficulty that many partnerships would have with the new election rules, the proposed regulations provide that PFIC elections previously made by a partnership would remain in effect as if made by the partners, and the IRS also requested comments on the potential of providing a way for a partnership to make PFIC elections on behalf of its partners.

Delayed PTP Withholding Regulations to Become Effective

In what may have come as a shock to some, the IRS and Treasury let the final regulations under Section 1446(f) requiring brokers to withhold on dispositions of publicly traded partnership (PTP) interests become effective on January 1, 2023. The regulations were finalized in 2020 and to be effective for transfers after January 1, 2022, but their effective date was delayed a year by the Treasury Department and IRS in Notice 2021-51. Generally, the final regulations require brokers who effect transfers of PTP interests to withhold 10% of the amount realized by the transferor unless the broker receives (i) a valid W-9 or W-8 claiming an exemption from withholding or that a reduced rate of withholding applies or (ii) a qualified notice from the publicly traded partnership (PTP) indicating that the 10%

exception under Treas. Reg. § 1.1446(f)-4(b)(3)(ii) applies. A broker is also not required to withhold on a qualified intermediary, or a U.S. branch treated as a U.S. person, that assumes primary withholding responsibility under Section 1446(f)(1).

As the end of the year approached without further guidance, brokers began sorting out their withholding obligations for PTP transactions and PTPs began fielding questions about whether they could provide a qualified notice for transfers of their interests. One of the difficulties created by the regulations is that a broker that is unable to determine the classification of an entity may be required to withhold on sales of interests in that entity unless the broker receives a qualified notice. The practical result is that withholding would generally apply to sales of every foreign (potentially) publicly traded partnership interest. On December 21, however, the IRS released Notice 2023-8 (PTP Notice) acknowledging the difficulty facing brokers in determining whether non-U.S. entities are PTPs for 1446(f) withholding purposes. In the PTP Notice, the government announced that it would propose regulations that would allow a broker to presume that an entity organized outside the United States is not a PTP unless the broker has actual knowledge to the contrary. Further relief is to be provided by allowing brokers to rely on late certifications of exemption or reduced withholding from transferors under certain circumstances. The additional guidance in the PTP Notice may be relied upon until regulations are promulgated.

While the guidance in the PTP Notice should help ease brokers' 1446(f) compliance burdens, the transition to broker withholding on PTP transfers may prove to be quite burdensome to both brokers and entities whose interests may be subject to the rules. Brokers may become less inclined to facilitate PTP trading. Or, maybe more likely, brokers, along with affected entities and investors, will work to comply while minimizing the incidence of withholding.

FIRPTA-Related Guidance

December also brought new guidance on exemptions from the *Foreign Investment in Real Property Tax Act* (FIRPTA) for interests in a "qualified investment entity" (QIE) and for qualified foreign pension funds (QFPFs). At the same time, regulations under Section 892 were proposed that should be helpful for foreign governments (including QFPFs) that make indirect investments in U.S. real estate.

Proposed QIE Regulations

Section 897(h)(2) provides that an interest in a domestically controlled qualified investment entity (QIE) is not a U.S. Real Property Interest (USRPI). A QIE is any REIT or RIC that would be treated as a U.S. Real Property Holding Corporation (USRPHC). A domestically controlled QIE is a QIE of which less than 50% of the value of its stock is held "directly or indirectly" by "foreign persons" at all times during the shorter of (1) the five-year period ending on the relevant determination date or (2) the period during which the QIE was in existence.

Under these rules, an interest in a domestically controlled QIE (DC QIE) is not a USRPI subject to U.S. federal income tax under FIRPTA, even if the DC QIE would otherwise be a USRPHC. Existing regulations under Section 897 provide that, for purposes of determining DC QIE status, the "actual owners" of stock (as determined under Treas. Reg. section 1.857-8(b)) must be considered. Generally, the actual owners for this purpose are the persons required to include the dividends received on the QIE stock in gross income. In a 2009 private letter ruling citing these regulations (PLR 200923001), the IRS ruled that REIT stock owned by a foreign person through a domestic C corporation is to be treated as owned by the domestic C corporation to determine DC REIT status and not as owned "indirectly" by the foreign person.

In a departure from the current guidance, the Treasury Department and IRS published proposed regulations on December 28, 2022, providing a look-through rule for purposes of determining whether a QIE is domestically controlled. To determine the percentage of domestic and foreign ownership under the proposed regulations, only "non-look-through persons" are treated as directly or indirectly holding stock of a QIE for purposes of determining whether a QIE is domestically controlled. Any shareholder that is a "look-through person" must be looked through until you get to the "non-look-through persons" that indirectly own the shares.[1]

The proposed regulations will apply to dispositions of interests in QIEs that occur after the date on which the proposed regulations are finalized. However, unless the proposed regulations are finalized with added transitional relief, the regulation will effectively be retroactive because of the five-year lookback period for making the determination of whether an entity is domestically controlled. Furthermore, the preamble to the proposed regulations states that "the IRS may challenge positions" taken by taxpayers that are contrary to the proposed regulations prior to their being finalized, indicating that the IRS may believe the look-through rule to be applicable under current law.

Given the possibility that the IRS may challenge DC QIE structures that would fail under the look-through rule and the retroactive effect of the regulations when finalized, entities that currently believe they qualify as a DC QIE, and their non-U.S. investors who rely on that status, should examine how they would be treated under the look-through rule and how to mitigate the risk that fluctuations in upper-tier ownership might cause status to be lost.

Final QFPF Regulations

QFPFs and entities wholly owned by QFPFs ("qualified controlled entities" or QCEs) are exempt from filing U.S. federal income tax returns and paying U.S. federal income tax on gain attributable to the disposition of USRPIs, unless that gain is otherwise effectively connected with the conduct of a U.S. trade or business. The Treasury Department and IRS released proposed QFPF regulations back in June of 2019, relating to qualification as a QFPF and withholding requirements for dispositions of USRPIs by QFPFs. On December 28, 2022, final regulations were published generally adopting those proposed regulations with certain changes that should be helpful for taxpayers on qualifying for QFPF status. The final regulations retain the requirement that a QFPF or QCE disposing of an USRPI generally must have satisfied the QFPF or QCE requirements, as applicable, for the 10-year period ending on the date of such disposition to benefit from the exemption with respect to such disposition. The final regulations also retain the requirement that a QCE be wholly owned by QFPFs in order to qualify as a QCE (i.e., no *de minimis* non-qualifying owners allowed), while providing for a limited transitional period for QCEs with *de minimis* (less than 5% by vote or value) service provider owners to come into compliance with the rules if the QCE becomes wholly owned by QFPFs by February 27, 2023, without tainting the QCE's ability to claim the exemption after it becomes compliant.

Proposed 892 Regulations

Generally, Section 892 exempts certain income derived by a foreign government from U.S. federal taxation. However, the exemption does not apply to income that is (i) derived from the conduct of a commercial activity, (ii) received by or from a controlled commercial entity of the foreign government (CCE) or (iii) derived from the disposition of an interest in a CCE. Under the current regulations, an entity controlled by a foreign government is treated as a CCE if 50% or more of its assets consist of USRPIs, including interests in USRPHCs. Under the proposed regulations, a controlled entity will not be a CCE for Section 892 purposes if the only reason it would be a CCE is that it holds interests in USRPHCs (that are not themselves controlled entities of the foreign government). The proposed regulations are to be effective for taxable years ending on or after December 28, 2022, and may be relied upon until finalized. This is welcome guidance that should simplify structuring indirect investments in U.S. real estate when foreign governments are significant investors.

Transfer Pricing

Last year we mentioned an important transfer pricing case, *Medtronic Inc. v Commissioner*, which addressed the appropriate transfer pricing method for intercompany patent licenses. Following remand from the Court of Appeals, the Tax Court's August 18, 2022, opinion rejected both the IRS's and the taxpayer's principal transfer pricing methods, and instead adopted an alternative method proposed by the taxpayer. Medtronic is a global medical device company, and the U.S. parent entered into license agreements with its Puerto Rican subsidiary to manufacture certain devices. Under the license agreements, the Puerto Rican subsidiary was required to pay a royalty to the U.S. parent for certain intangible assets it used for development, manufacturing and commercialization of the medical devices. After two bouts of review by the Court of Appeals, the Tax Court adopted an unspecified method and determined an overall profit split of 69% to the U.S. parent and 31% to the Puerto Rican subsidiary, and a wholesale royalty rate of 48.8%.

As with most transfer pricing issues, the Medtronic case is fact-specific, but it shows that the Tax Court may be flexible in adopting or crafting "best" transfer pricing methods to come as close as possible to arms' length results.

BEPS: Pillar Two

At the start of 2022, it was unclear how much progress would be made on the BEPS project, but the year closed with significant news for Pillar Two. On December 15, 2022, the EU member states unanimously adopted a minimum tax directive, reaching agreement in principle that each of the EU member states would adopt Pillar Two minimum tax reforms. Following the adoption of the directive, OECD released further guidance on Pillar Two and the Global Anti-Base Erosion (GloBE) Rules, which are intended to ensure multinational taxpayers with revenues above EUR750 million (USD$815 million) pay a minimum effective tax rate of 15% in each nation in which the taxpayer operates.

Responding to concerns about the complexity of compliance with the GloBE Rules, the OECD announced certain safe harbors that should be made available to multinational taxpayers. The safe harbors aim to alleviate the compliance burden on taxpayers by allowing them to exclude income from certain lower-risk jurisdictions from the scope of the GloBE Rules if the taxpayer meets certain requirements (e.g., *de minimis* revenue, no "excess profits") and to use simplified calculations of income, revenue and tax when determining whether they meet those requirements. The OECD also described a "Transitional Penalty Relief Regime" under which a member state should take into consideration a multinational taxpayer's reasonable efforts to comply with the GloBE Rules when weighing whether to assess penalties for incomplete or incorrect application of the Rules. On February 2, 2023, the OECD released guidance to assist governments with implementing the global minimum tax, which includes guidance on the treatment of the United States global intangible low-taxed income (GILTI) regime under the GloBE rules and on the design of "qualified domestic minimum top-up taxes." Further guidance is expected to be released on a rolling basis – should be quite an eventful year for the BEPS project.

Update on Tax Treaties

In March 2022, the Senate Committee on Foreign Relations approved the U.S.-Chile Treaty for full Senate consideration, and on December 7, 2022, the United States and Croatia signed their first tax treaty – this is the first full treaty signed after the 2017 *Tax Cuts and Jobs Act* and on the basis of the 2016 U.S. Model Treaty. In the other direction, the U.S. Treasury Department announced that Hungary was notified on July 8, 2022, that the United States would terminate its tax treaty with Hungary. The reason given for termination was Hungary's reduction of its domestic corporate income tax rate to 9.9% – less than half of the 21% U.S. rate, and that the benefits of the treaty were no longer mutual. But general consensus is that the termination was an attempt to pressure Hungary to drop its veto of the OECD's minimum tax directive (discussed above) – which, in December, Hungary did. Nevertheless, the termination notice was not rescinded, and therefore the termination of the U.S.-Hungary tax treaty is effective in 2023, with certain benefits continuing through January 1, 2024.

Look Ahead to 2023

The headline U.S. tax event for 2022 was certainly the *IRA*, with its new corporate alternative minimum tax, stock buyback excise tax and a plethora of new and extended tax credits, but the regulatory and case law developments were significant as well. With Republicans controlling the House of Representatives, it seems unlikely that this year will bring any major tax legislation from Washington.

However, this look ahead comes hot on the heels of President Biden's State of the Union Address on February 7, 2023, in which the President indicated a desire to try to work with Republicans to pass tax legislation. We also expect the Biden administration will push the Treasury and IRS to provide guidance on the *IRA*'s tax provisions while the agencies also attend to ongoing regulatory projects. In addition, the Supreme Court is set to rule this year on several important tax-related cases. Specifically, we have our eyes on *In re Grand Jury*, regarding the scope of privilege with respect to communications that mix tax planning and return preparation advice, and *Bittner v United States*, regarding whether penalties for late-filed FBARs apply on a year-by-year basis or account-by-account basis. Given the expectation for more regulatory action and the possibility of more legislation, this year seems certain to be full of new tax developments. Check back in with us next year to see how it went.

[1] "Non-look-through persons" include only individuals and estates, domestic corporations (other than "foreign-owned domestic corporations," S corporations and non-public REITs or RICs), publicly traded QIEs, nontaxable holders, foreign corporations, publicly traded partnerships (domestic or foreign), international organizations and QFPFs and their "qualified controlled entities" (QCEs).
"Look-through persons" are any person other than a "non-look-through person" including certain REITs/RICs, S corporations, non-publicly traded partnerships (domestic or foreign), trusts (domestic or foreign) and "foreign-owned domestic corporations" (any non-publicly traded domestic C corporation, if foreign persons directly or indirectly hold 25% or more of the value of its outstanding stock).

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