Bloomberg Tax

Tax Management International Journal™

Vol. 47, No. 6 June 8, 2018

ARTICLES

363 **How Do the New Rules for Sales of Partnership Interests Interact With Income Tax Treaties?**
By Nils Cousin

367 **A COGS Primer for BEATniks**
By James Atkinson, Joseph Hainly, Jessica Slean, and Eric Lucas

378 **The Ins and Outs of Domestication of Foreign Trusts**
By Jennifer J. Wioncek

390 **My Big Fat *Grecian* Divorce: A Labyrinthine Tale of ECI**
By Alfred H. Bae, Esq.

CANADA-U.S. INVESTMENT: CANADIAN TAX PERSPECTIVE

398 **Elimination of 30-Day Requirement and Impact on Cross-Border Estate Planning for Canadian Families**
By Gregg M. Benson, Rhonda Rudick, and Peter A. Glicklich

LEADING PRACTITIONER COMMENTARY

403 **The New Enhanced Lifetime Exemption Under Most U.S. Estate Tax Treaties**
By Thomas S. Bissell, CPA

405 **Top Ten Reasons To Limit §958(b)(4) Repeal**
By Kimberly S. Blanchard, Esq.

407 **Update on OECD Transfer Pricing Guidance**
By David Ernick

410 **Subpart F and the BEAT**
By Lowell D. Yoder, Esq.

LEGISLATION

413 **Current Status of Legislation Relating to U.S. International Tax Rules**
By Sean Hailey, CPA, and Stephen Peng, Esq.

SUBSCRIBER NOTICE

There are no new treaty updates this month. For the most recent update, see the May 11, 2018, issue of TMIJ.

BLOOMBERG TAX U.S. INTERNATIONAL ADVISORY BOARD

John Harrington, Esq., Chair
Dentons US LLP, Washington, D.C.

Daniel Z. Altman, Esq.
Sidley Austin LLP
New York, New York

Richard E. Andersen, Esq.
Wilmer Cutler Pickering Hale & Dorr LLP
New York, New York

Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

Peter H. Blessing, Esq.
KPMG LLP
New York, New York

Michael J. Caballero, Esq.
Covington & Burling, LLP
Washington, D.C.

Martin J. Collins, Esq.
PricewaterhouseCoopers LLP
Washington, D.C.

Alan Fischl, Esq.
PricewaterhouseCoopers LLP
Washington, D.C.

Peter A. Glicklich, Esq.
Davies Ward Phillips & Vineberg LLP
New York, New York

Heléna M. Klumpp, Esq.
Ivins, Phillips & Barker, Chartered
Washington, D.C.

Stephen R. LaSala, Esq.
Formerly of Exxon Mobil
Dallas, Texas

Leonard Levin, Esq.
O'Connor Davies LLP
New York, New York

Kimberly Tan Majure, Esq.
KPMG LLP
Washington, D.C.

Samuel M. Maruca, Esq.
Covington & Burling, LLP
Washington, D.C.

Michael J. Miller, Esq.
Roberts & Holland LLP
New York, New York

Jose Murillo, Esq.
Ernst & Young LLP
Washington, D.C.

Fred Murray, Esq.
University of Florida School of Law
Gainesville, Florida

Stephen A. Nauheim, Esq.
PricewaterhouseCoopers LLP
Washington, D.C.

Joshua Odintz, Esq.
Baker & McKenzie LLP
Washington, D.C.

Paul Schmidt, Esq.
Baker & Hostetler LLP
Washington, D.C.

Gary D. Sprague, Esq.
Baker & McKenzie LLP
Palo Alto, California

Dirk J.J. Suringa, Esq.
Covington & Burling, LLP
Washington, D.C.

Edward Tanenbaum, Esq.
Alston & Bird LLP
New York, New York

James J. Tobin, Esq.
Ernst & Young LLP
New York, New York

Robert E. Ward, Esq.
Ward Chisholm, P.C.
Bethesda, Maryland

John P. Warner, Esq.
Buchanan Ingersoll & Rooney PC
Washington, D.C.

Lowell D. Yoder, Esq.
McDermott Will & Emery LLP
Chicago, Illinois

TAX MANAGEMENT

Gregory C. McCaffery, *Chairman*
Josh Eastright, *CEO*
Darren McKewen, *President, Bloomberg Tax*
Lisa Fitzpatrick, *VP & General Manager*

George R. Farrah, CPA, *Editorial Director*
Dolores Gregory, *Managing Editor*
Larry Frank, *Writer/Editor*

Bloomberg Tax

Tax Management International Journal (ISSN 0090-4600) is published monthly, at the annual subscription rate of $1,182 per year, for a single print copy by The Bureau of National Affairs, Inc, 1801 South Bell St., Arlington, VA 22202. **Periodicals Postage Paid at** Arlington, VA and at additional mailing offices. **POSTMASTER:** Send address changes to Tax Management International Journal, BNA Customer Contact Center, 1801 South Bell St., Arlington, VA 22202.

Copyright Policy: Reproduction of this publication by any means, including facsimile transmission, without the express permission of Tax Management Inc. is prohibited except as follows: 1) Subscribers who have registered with the Copyright Clearance Center and who pay the $1.00 per page per copy fee may reproduce portions of this publication, but not entire issues. The Copyright Clearance Center is located at 222 Rosewood Dr., Danvers, MA 01923. Tel. (508) 750-8400; 2) Permission to reproduce Tax Management material otherwise can be obtained by calling (703) 341-5937. Fax (703) 341-1624.

Copyright © 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., Arlington, VA 22202, U.S.A.

ARTICLES

How Do the New Rules for Sales of Partnership Interests Interact With Income Tax Treaties?

By Nils Cousin[*]

In the 2017 tax act,[1] Congress enacted §864(c)(8), which codified the result of Rev. Rul. 91-32[2] — that when a foreign person sells an interest in a partnership which is engaged in the conduct of a U.S. trade or business, all or a portion of the gain or loss from such sale must be treated as effectively connected income (ECI). Because it is effectively connected with the conduct of a U.S. trade or business, it is therefore subject to U.S. federal income tax under §871(b) or §882.

Although the Internal Revenue Service has consistently taken this position, taxpayers prior to enactment of §864(c)(8) frequently argued that the IRS analysis in the Rev. Rul. 91-32 was incorrect. In a 2017 decision, the U.S. Tax Court agreed, ruling in *Grecian Magnesite*[3] that the IRS had incorrectly applied existing law. Congress enacted §864(c)(8) in response. However, the focus of §864(c)(8) differs from the analysis that Rev. Rul. 91-32 would have mandated. The result may be that taxpayers that are eligible for the benefits of an income tax treaty between the United States and their countries of residence may continue to be exempt from U.S. federal income tax on gains from the sales of partnership interest in appropriate circumstances.

This article explains the IRS's reasoning under Rev. Rul. 91-32 and why taxpayers — and the Tax Court — disagreed with it, as well as explaining the impact of this analysis on income tax treaties. It then addresses the mechanism of §864(c)(8) and why the new provision may not apply in the tax treaty context. The conclusion is that there is a misconception that §864(c)(8) codified Rev. Rul. 91-32; rather, §864(c)(8) codified merely the result reached in the revenue ruling, but in such a way that taxpayers that can claim benefits under an income tax treaty may be able to continue taking advantage of the reasoning of *Grecian Magnesite*.[4]

PRIOR LAW APPLICABLE TO PARTNERSHIP INTEREST SALES

Under §741, the sale of a partnership interest generally is treated as the sale of a capital asset. Section 865(a)(1) provides that sales of personal property, including partnership interests, are sourced to the residence of the seller, so that a foreign resident selling a partnership interest generally has foreign-source gain.[5] However, §865(e)(2) may override this result. It provides that if a foreign person has a U.S. office or fixed place of business to which the sale is attributable, then the gain is treated as from U.S. sources.

Treating gain as from U.S. sources under this rule is the first step to taxing such gain. If the foreign taxpayer has U.S.-source gain, it would be subject to U.S. federal income tax as ECI if either an asset use test (which asks if the partnership interest is an asset used or held for use in the taxpayer's U.S. trade or business) or a business activities test (which asks if the U.S. trade or business activities of the taxpayer gave rise to the gain) is satisfied.[6]

It is clear that if a partnership is engaged in the conduct of a U.S. trade or business, its partners are also treated as engaged in the conduct of a U.S. trade or business.[7] It is also clear that a U.S. office or fixed place of business of a partnership is attributed to its partners.[8] However, it is not sufficient that the partner has a U.S. office or fixed place of business. The gain

[*] Nils Cousin is a Director in PricewaterhouseCoopers's Washington National Tax Services office and is a member of the International Tax Services group. He is also an adjunct professor at Georgetown University Law Center and co-author of the Bloomberg Tax portfolio on FATCA: 6565 T.M., *FATCA — Information Reporting and Withholding Under Chapter 4*. He wishes to thank his colleagues Steven A. Nauheim and Todd McArthur for their assistance with this article. The views expressed in this article are the author's only and not those of PwC.

[1] Pub. L. No. 115-97, known informally as the Tax Cuts and Jobs Act.

All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder.

[2] 1991-1 C.B. 107.

[3] *Grecian Magnesite Mining v. Commissioner*, 149 T.C. 3 (July 13, 2017), notice of *appeal filed*, No. 17-1268 (D.C. Cir. Dec. 15, 2017).

[4] At the time of writing, the Tax Court's decision in *Grecian Magnesite* is still pending appeal. Should the Court of Appeals reverse the Tax Court, then the reasoning of such a reversal could impact the application of tax treaties. Even if the Court of Appeals affirms, there is the possibility that it issues an opinion that applies a different analysis than the Tax Court.

[5] This assumes the partnership interest is not inventory property of the selling taxpayer. Foreign-source gain from the sale of non-inventory personal property is not subject to U.S. federal income tax. *See* §864(c)(4).

[6] §864(c)(2).

[7] §875(1).

[8] Section 875 provides that if a partnership is engaged in the conduct of a U.S. trade or business, its partners are treated as also

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

from the sale of the partnership interest must also be attributable to such office or fixed place of business.[9] This requires that the office be a material factor in producing the gain and regularly engages in the types of transactions that generated the gain. Treasury regulations provide that, with respect to sales of personal property, an office is a material factor if, for example, it materially participates in negotiating the sale.[10]

The IRS concluded in Rev. Rul. 91-32 that, because the partnership's U.S. office's activities were responsible for increasing the value of the partnership interest so that the partner could sell it at a gain, the gain from the sale of the interest is automatically attributable to such U.S. office. This reasoning disregarded the requirement that the sale of the partnership interest is treated as the sale of a capital asset, and that the question to be answered is whether the U.S. office materially participated in the sale transaction.[11] The Tax Court held that the IRS had incorrectly applied the law and that, under the facts of the *Grecian Magnesite* case, the partnership's U.S. office had neither materially participated in negotiating the partner's disposition of the partnership interest nor regularly participated in such transactions.

Under the revenue ruling's reasoning, once the gain is U.S. source, the IRS applied a similar logic to the determination of whether the gain was ECI — because the partnership's U.S. trade or business increased the value of the partnership interest, the gain is effectively connected with the conduct of such trade or business. While the Tax Court's decision did not need to conclude whether this reasoning was also incorrect, it should be noted that the question under the Treasury regulations is whether the partnership interest itself is an asset held in the selling partner's U.S. trade or business, a factor that similarly was not present in the *Grecian Magnesite* case.

Even under the Tax Court's reasoning in *Grecian Magnesite*, it is possible that gain from the sale of a partnership interest could be ECI. For example, the selling partner could itself have a U.S. office or fixed place of business that is a material factor in negotiating its sale of the partnership interest, and the partnership interest could be an asset held in the conduct of such partner's U.S. trade or business (e.g., as a dealer in partnership interests). Under such an analysis, leaving aside U.S. real property interests (USRPI) held by a partnership, either no gain from the sale is ECI, or all the gain is ECI.[12]

ANALYSIS UNDER INCOME TAX TREATIES

Generally speaking, most income tax treaties follow a similar approach as that described above under domestic law. Most treaties to which the United States is a party have an article addressing capital gains permitting the United States to tax gains of a resident of the treaty partner derived from the alienation of real property situated in the United States.[13] Those treaties may further provide a look-through rule under which the United States may tax such gain where the resident alienates a partnership or trust interest to the extent that the assets of the partnership or trust consist of real property situated in the United States.[14]

Moreover, the United States may tax gains from the alienation of personal property by a resident of the treaty partner if such personal property forms part of the business property of a permanent establishment that the treaty resident has in the United States, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise).[15] Outside of these two contexts (and with certain other provisions not relevant to this analysis), the United States may not tax gains from the alienation of any property not specifically addressed above.[16]

Thus, under an income tax treaty — again leaving aside USRPI held by the partnership — the United

---

so engaged. While §875 does not specifically attribute the partnership's U.S. office to its partners, the legislative history makes clear that Congress intended this result. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 225 (1988).

[9] §865(e)(3), §864(c)(5).

[10] Reg. §1.864-6(b)(1); see also Reg. §1.864-6(b)(2)(ii) for analogous rules addressing sales of securities.

[11] To the extent the partnership holds U.S. real property interests, §897(g) mandates treating a portion of the gain as if realized from sales of the underlying real property interests, with a result that such gain is taxable as ECI under §897. The fact that Congress provided for such a clear look-through rule in this limited context was a factor that the Tax Court noted, reasoning that the absence of a similar look-through rule for sales of partnership interests more generally indicated that it was not appropriate to apply such a rule more broadly.

[12] Even if the reasoning of Rev. Rul. 91-32 is followed, it is unclear how the IRS concluded that only the portion of the gain attributable to trade or business assets of the partnership would be ECI; the IRS did not explain how, if the U.S. office of the partnership is a material factor in the sale of the partnership interest, it would be a material factor only with respect to the portion of the gain attributable to assets used in the partnership's U.S. trade or business.

The Tax Court also left open the possibility that if the partnership had §751 assets, gain attributable to such assets could be ECI.

[13] *See* 2016 U.S. Model Tax Treaty, art. 13(1). The 2016 U.S. Model Tax Treaty is, with respect to gains, materially identical to the 2006 U.S. Model as well as to most currently in-force tax treaties to which the United States is a party.

[14] 2016 U.S. Model Tax Treaty, art. 13(2)(c)(ii).

[15] 2016 U.S. Model Tax Treaty, art. 13(3).

[16] 2016 U.S. Model Tax Treaty, art. 13(5). Each treaty is a separately negotiated document whose provisions, including the gains article, may vary.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

States may impose tax on the sale of personal property such as a partnership interest if the partnership interest forms part of the business property of a permanent establishment that the selling partner has in the United States. Similar to the above analysis, a U.S. permanent establishment of a partnership is attributable to its partners. However, also similarly to the analysis above, the partner in this case is not directly alienating the permanent establishment or its business property, but instead is alienating a partnership interest. As stated above, the Tax Court held that it is the partnership interest itself, not the partnership's assets, which is treated as alienated for U.S. federal income tax purposes.[17] Thus, unless the partner itself has a U.S. permanent establishment and the partnership interest is an asset of that permanent establishment, arguably the United States may not tax the gain therefrom.

It is likely that Congress could have given effect to the result intended by Rev. Rul. 91-32 not only in the domestic law context, but also in the context of income tax treaties' articles addressing gains. As discussed below, however, the approach taken by §864(c)(8) does not follow the analysis of the ruling, with the result that §864(c)(8) may leave room for an analysis such as in *Grecian Magnesite* when determining whether an income tax treaty exempts gain from the sale of a partnership interest from U.S. federal income tax.

THE §864(c)(8) APPROACH

Congress, in order to codify the result of Rev. Rul. 91-32, could have provided a rule under which gain from the sale of a partnership interest would be treated as attributable to a U.S. office or fixed place of business and as derived from assets used in a U.S. trade or business. Such a rule would likely have the effect not only of causing the gain to be treated as ECI, but also of denying treaty benefits — because, for purposes of applying an income tax treaty, the gain would be treated as gain from alienating the permanent establishment itself rather than gain from selling a partnership interest.

However, Congress left the entity approach of §741 and the source rules of §865(e)(2) untouched. Instead, §864(c)(2) merely provides a separate rule whereby a portion of the gain from the sale of the partnership interest is deemed to be ECI on a look-through basis, without treating the selling partner as actually selling the partnership's assets. Thus, for domestic law purposes, §864(c)(8) does not change the prior analysis under *Grecian Magnesite*; it merely makes it irrelevant. However, nothing in §864(c)(8) addresses the impact of income tax treaties, and no specific treaty override is included.[18] While a statute that conflicts with a treaty may override the treaty if the statute was enacted later in time than the treaty entered into force, courts generally do not apply the later-in-time rule where the apparent conflict between the two provisions can be resolved and both provisions can be given effect.[19]

Here, the two provisions are arguably not in conflict. Section 864(c)(8) provides a rule that states that, while the sale of a partnership interest is the sale of a single asset (the partnership interest) and while such gain may be foreign-source under §865 and not be ECI under the rules of §864(c)(2)–§864(c)(7), a portion of such gain will nevertheless be deemed ECI. The gains article of an income tax treaty provides the circumstances under which the U.S. may impose federal income tax on such gains, and it arguably provides that where an asset such as a partnership interest is alienated, the U.S. may not impose federal income tax on gains from such sale unless the partnership interest is part or all of the business property of the partner's U.S. permanent establishment.

In other words, §864(c)(8) is likely a characterization rule, not a taxing rule. Once characterization is determined, §871, §881, and §882 apply to determine whether U.S. federal income tax is imposed on the income. It is clear, however, that if income is ECI and taxable under domestic law, the treaty then applies to determine whether there is any restriction on the U.S.'s ability to tax the ECI.

Moreover, the need to keep the treaty analysis separate from the ECI analysis is also apparent in the context of a partnership that is engaged in the conduct of a U.S. trade or business but that does not have a U.S. permanent establishment. In such a case, notwithstanding that the operating income of the partnership is ECI, foreign partners that qualify for treaty benefits

[17] It should be noted that while the Treasury Department has not released its technical explanation to the 2016 U.S. Model Treaty, the technical explanation to the 2006 and the 1996 Model, which contains materially identical provisions, cites Rev. Rul. 91-32 in support of a statement that gains from the sales of partnership interests will be treated as attributable to a U.S. permanent establishment to the extent the partnership has a permanent establishment. However, due to the similarities in analysis between domestic tax law and income tax treaties in this regard, it is likely that the *Grecian Magnesite* analysis would apply equally in the income tax treaty context.

[18] Due to the budget reconciliation process used to pass the 2017 tax act in the Senate, no provisions of the Act contain explicit treaty overrides of an income tax treaty. Explicit treaty overrides would have been in the jurisdiction of the Senate Foreign Relations Committee, which was not given a reconciliation construction; accordingly, any specific treaty override would have been out of the scope of the reconciliation process and subject to a 60-vote point of order.

[19] *See Posadas v. Nat'l City Bank of N.Y.*, 296 U.S. 497, 503 (1936); *The Cherokee Tobacco*, 78 U.S. 616 (1870).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

would be exempt from U.S. federal income tax on such ECI because the profits are not attributable to a U.S. permanent establishment.[20] If the partner sells its interest in the partnership, §864(c)(8) would apply to treat gain or loss as ECI; however, in this scenario, the gain arguably would not be attributable to a U.S. permanent establishment even if a pure look-through approach such as used in Rev. Rul. 91-32 were applied; accordingly, absent a specific treaty override, policy considerations should lead to the treaty controlling.

Although the policy for not applying the treaty may be stronger where the partnership does have a U.S. permanent establishment, it remains the case that §864(c)(8) does not purport to override income tax treaties and does not modify the general rule of §741 that a sale of a partnership interest is treated for U.S. federal income tax purposes as a sale of personal property (i.e., the interest) rather than as a sale of the partnership's underlying assets, and that the treaty's gains article provides a rule regarding the sale of personal property that permits taxation only where the personal property being sold is itself a permanent establishment or an asset of a permanent establishment.

Thus, under this approach, taxpayers that benefit from income tax treaties may potentially continue to take the position that their gains from sales of partnership interests are not subject to U.S. federal income tax. It should be noted that the IRS might not agree with this approach, but may continue to seek to apply the approach of Rev. Rul. 91-32. While a taxpayer may ultimately be successful in asserting a position, the practical impact of the likely IRS view is that the IRS would be unlikely to provide for an exemption from §1446(f) withholding for taxpayers that qualify for treaty benefits. As a result, such taxpayers would likely need to file for a refund of U.S. federal income tax, which may invite the IRS to challenge such a refund claim.

CONCLUSION

Section 864(c)(8) has been described as a codification of Rev. Rul. 91-32. However, a more accurate description may be that it codified the result in Rev. Rul. 91-32, but did not codify the approach used in the ruling to get to that result. Accordingly, while the effect of §864(c)(8) causes a portion of gains or losses from the sale of a partnership interest to be ECI if the partnership is engaged in the conduct of a U.S. trade or business, foreign persons that qualify for benefits of an income tax treaty can potentially continue to assert that gains from the sale of partnership interests are not subject to U.S. federal income tax (except to the extent attributable to USRPI of the partnership) notwithstanding that such gains are ECI under §864(c)(8).

[20] Assuming that the type of income received is not specifically addressed in another article of the relevant treaty and such article permits the United States to impose tax (e.g., an article addressing real property interests, or an interest article in a treaty such as the U.S.-Italy treaty that permits imposing up to 10 percent tax on the gross amount of interest).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

A COGS Primer for BEATniks

By James Atkinson, Joseph Hainly, Jessica Slean, and Eric Lucas[*]

The new Base Erosion Anti-Abuse Tax (BEAT),[1] added to the Internal Revenue Code by the law known colloquially as the Tax Cuts and Jobs Act (referred to herein as the ''2017 tax act''),[2] places a premium upon the distinction between expenditures properly classified as ''costs of goods sold'' (COGS) and those that are deductible as ordinary and necessary business expenses. The intricacies of the BEAT itself are better left to those practicing in the international tax sphere. For our purposes, suffice it to say that ''BEAT-able'' payments (certain deductible intercompany payments subject to the new minimum tax) do not include payments that otherwise constitute ''cost of goods sold.'' This article instead provides a high-level review of the scope of those costs properly classified as ''costs of goods sold'' for federal income tax purposes, including for purposes of avoiding BEAT liability.

Overall, this discussion focuses on three broad categories of costs: costs of acquiring or producing property subject to the uniform capitalization rules of §263A (''UNICAP''), costs of acquiring or producing property not subject to UNICAP, and costs incurred by traditional service providers.

COGS UNDER UNICAP

In its broadest sense, the costs of acquiring or producing property sold to customers encompasses more than just costs required to be capitalized by reason of §263A. In actuality, however, the detailed capitalization rules of that provision provide a solid foundation for identifying the vast majority of costs that will be treated as COGS for purposes of the BEAT.

Section 263A is an attempt by Congress to ensure that companies capitalize (and eventually recover as COGS) all direct and indirect costs incurred in either producing property or in acquiring property to be held for resale to customers. ''Production'' broadly includes constructing, building, installing, manufacturing, developing, improving, creating, raising, or growing.[3] A reseller includes a retailer, wholesaler, or other taxpayer.[4]

Depending upon whether it retains the benefits and burdens of ownership during the production period, a taxpayer might be a producer (rather than a reseller) for purposes of §263A, even if it relies upon contract manufacturers.[5]

Correctly classifying the taxpayer as either a producer or a reseller is important. While resellers must capitalize as COGS any includible costs incurred in acquiring real property or *any* personal property to be held for resale (whether tangible or intangible), producers are required to capitalize costs incurred only in connection with producing real or *tangible* personal property. This distinction proves central when discussing COGS in connection with software and/or software as a service (SaaS) and various forms of creative property, such as films, publishing, and sound recordings.

Certain taxpayers and certain types of property are specifically excluded from the scope of UNICAP. For example, §263A does not apply to costs deductible under §174 as research and experimentation expenses;[6] certain contracts accounted for under the long-term contract rules of §460;[7] certain farming businesses;[8] certain property provided incident to services,[9] and a laundry list of various other exclusions.[10] Section 263A and its regulations also apply various exceptions for taxpayers meeting the definition of a ''small taxpayer.''[11]

Otherwise, §263A requires all producers and resellers to capitalize direct and indirect costs incurred in connection with their production activities or in acquiring property to be held for resale. Once a taxpayer has identified its pool of costs subject to §263A, the taxpayer must allocate those costs between ending inventory and costs of goods sold using one of several methods provided for in the regulations.[12] Further discussion of these allocation methods is beyond the scope of this article as the focus under the BEAT regime is whether such costs can be included in inventory under §263A in the first place, not necessarily when they will be included in COGS under the taxpayer's allocation method.

A taxpayer determines its taxable income (in part) by beginning with its opening inventory, adding the

---

[*] James Atkinson and Eric Lucas are principals and Jessica Slean a manager with the Income Tax & Accounting group of KPMG Washington National Tax. Joseph Hainly is a managing director leading KPMG's Accounting Methods and Credit Services practice in Boston.

The authors wish to thank Kimberly Majure, the leader of the inbound tax practice of KPMG Washington National Tax, for her technical assistance on BEAT.

[1] §59A. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder.

[2] Pub. L. No. 115-97, §14401.

[3] §263A(g). *See generally* Reg. §1.263A-2.

[4] *See generally* Reg. §1.263A-3.

[5] §263A(g)(2). *Suzy's Zoo v. Commissioner*, 273 F.3d 875 (9th Cir. 2001), *aff'g* 114 T.C. 1 (2000). *Cf. ADVO, Inc. v. Commissioner*, 141 T.C. 298 (analyzing ''benefits and burdens'' standard for contract manufacturing under former §199).

[6] §263A(c)(2).

[7] §263A(c)(4).

[8] §263A(d).

[9] Reg. §1.263A-1(b)(11).

[10] Reg. §1.263A-1(b).

[11] §263A(i).

[12] *See, e.g.,* the simplified methods under Reg. §1.263A-2(b) and §1.263A-3(d).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

costs of new acquisitions made during the year (essentially, its §263A costs), and subtracting its ending inventory. The result is the taxpayer's COGS for the year. COGS is then subtracted ''above-the-line'' from the taxpayer's total sales in computing its gross income for the year.[13] ''Below-the-line'' items such as ordinary and necessary business expenses are then deducted from gross income to derive the taxpayer's taxable income for the year.

Accordingly, while discussions of BEAT typically are phrased in terms of whether particular expenditures are ''includible in COGS,'' the determination is more accurately described as whether particular costs are ''above-the-line'' production or acquisition costs required to be capitalized under §263A, which then become part of the overall calculation of the taxpayer's ending inventory and its COGS for the year (with the year's production costs typically split between the year's ending inventory and the year's COGS).

Direct Costs

Identifying the direct costs required to be capitalized by §263A tends to be straightforward. Producers must capitalize direct material costs and direct labor costs. Direct material costs are those that can be identified or associated with specific items that have been produced and that either become an integral part of that property or are consumed in the ordinary course of its production. This would include, for example, costs of raw materials as well as materials and supplies.[14]

Similarly, direct labor costs capitalized by producers include the costs of labor that can be identified or associated with particular items that have been produced. This includes costs incurred for both full- and part-time employees, as well as contract employees and independent contractors. Elements of direct labor include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.[15]

For resellers, direct costs include the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost generally is the invoice price less trade or other discounts, plus transportation and other acquisition costs.[16]

Indirect Costs

In addition to direct costs, producers and resellers must capitalize indirect costs properly allocable to the production or resale activities. For this purpose, indirect costs are properly allocable to property produced or acquired for resale when the costs ''directly benefit or are incurred by reason of'' the production or resale activities.[17] In *Robinson Knife*,[18] the U.S. Tax Court distills that provision down to a ''but-for'' causation test. In other words, any costs that would not have been incurred *but for* the production or resale activities are considered allocable to the production or resale activities.

Importantly, in light of its loss in the Second Circuit's decision in *Robinson Knife*,[19] the government amended the §263A regulations in 2014[20] to provide that indirect costs may directly benefit or be incurred by reason of the performance of production or resale activities even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory. This rule is particularly relevant in the context of ''sales-based royalties,'' discussed below.

Helpfully, the §263A regulations provide two lists setting forth the indirect costs that generally must be capitalized as production costs, and those that generally do not.

[13] Reg. §1.61-3.

[14] Reg. §1.263A-1(c)(2)(i)(A).

[15] Reg. §1.263A-1(c)(2)(i)(B).

[16] Reg. §1.263A-1(c)(2)(ii), §1.471-3(b).

[17] Reg. §1.263A-1(e)(3)(i).

[18] *Robinson Knife Co. v. Commissioner*, 600 F.3d 121 (2d Cir. 2010), *rev'g* T.C. Memo 2009-9.

[19] *Id.*

[20] T.D. 9652 (Jan. 10, 2014).

Indirect Costs Potentially Required to Be Capitalized	Indirect Costs Not Required to Be Capitalized*
Indirect labor costs	Selling and distribution costs
Officer's compensation	Research and experimentation costs
Pension and other related costs	§179 costs
Employee benefit expenses	§165 losses
Indirect materials costs	Cost recovery allowances on temporarily idle equipment
Purchasing costs	Income taxes
Handling costs	Strike expenses
Storage costs	Warranty and product liability (even if embedded in sales price)
Cost recovery	On-site storage costs

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Depletion	Unsuccessful bidding expenses
Rent	Deductible service costs (see Service Costs section below for additional details)
Taxes (excluding income-based)	
Insurance	
Utilities	
Repairs and maintenance	
Engineering and design costs (other than §174 costs)	
Spoilage	
Tools and equipment	
Quality control	
Successful bidding costs	
Licensing and franchise costs (see Sales-Based Royalties section below for additional details)	
Interest	
Capitalizable service costs (see Service Costs section below for additional details)	

*See Optional Capitalization section below for a discussion on whether costs that are not required to be capitalized to inventory are eligible for capitalization.

For any of the indirect costs identified as potentially capitalizable, the threshold requirement is that the cost is properly allocable to property produced or property acquired for resale. Thus, for example, while officer's compensation is listed as a capitalizable indirect cost, that is true only to the extent the officer's time relates to production or resale activities, as opposed to, for example, corporate policy. Similarly, while costs incurred to repair or maintain a production facility must be capitalized as an indirect cost, expenditures for repairing or maintaining a corporate office building or retail store fall outside the requirement, because of the lack of a factual nexus with activities to produce property or to acquire property for resale. As such, while these lists are helpful guidelines, the overriding requirement that a cost have a sufficient factual nexus with a production or resale activity must be top of mind.

Pre- and Post-Production Costs

Section 263A requires treating as production costs (and thus potentially as COGS) certain costs incurred both before and after the actual production period. Thus, producers are required to capitalize direct and indirect costs allocable to property that is held for future production (e.g., purchasing, storage, handling, and similar costs), even though production has not yet begun. For example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production.

Capitalizing pre-production costs is required so long as it is ''reasonably likely'' that production will occur at some future date. For example, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.[21] Construction companies must capitalize under §263A costs incurred in obtaining permits and variances, negotiating permit fees, and in conducting engineering and feasibility studies,[22] as well as costs incurred in designing speculative and custom-built buildings.[23]

Producers generally also must capitalize ''post-production costs.'' This would include, for example, storage and handling costs incurred after production is completed, but before the property enters the sales and third-party distribution process.

Purchasing, Handling, and Storage Costs

Resellers may have to capitalize as acquisition costs certain costs of purchasing, handling, and storing property acquired for resale. These are the indirect costs most often incurred by resellers. Although the specific rules applicable to purchasing, handling, and storage costs are set forth in the regulations specifically applicable to resellers, they are explicitly applicable to producers as well.

Purchasing costs are those associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., buyers, assistant buyers, and clerical workers) relating to:

- The selection of merchandise,
- The maintenance of stock assortment and volume,
- The placement of purchase orders,

[21] Reg. §1.263A-2(a)(3)(ii).

[22] *Von-Lusk v. Commissioner*, 104 T.C. 207 (1995).

[23] *Frontier Custom Builders v. Commissioner*, T.C. Memo 2013-231.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- The establishment and maintenance of vendor contracts, and
- The comparison and testing of merchandise.

In general, the nature of a person's duties rather than the person's title or job classification will determine whether the person is engaged in ''purchasing activities.'' Costs allocable to an individual who performs both purchasing and non-purchasing duties must be allocated between the activities.

Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale. For this purpose, processing means making minor changes or alterations to a product acquired for resale. Handling costs incurred at a retail sales facility are not required to be capitalized. Assembling activities include incidental activities that are necessary to ready the property for resale, such as attaching wheels and handlebars to bicycles.

The treatment of transportation costs depends upon the starting and ending points of the trip. Generally, transportation costs are those incurred by the taxpayer in moving or shipping property acquired for resale. These include the costs of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking inventory. Transportation costs also may include depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs.

Not all transportation costs are capitalized under §263A as handling costs, however. Instead, transportation costs incurred by producers and resellers are capitalized (and potentially included in COGS) if they involve transporting property:

- From the vendor to the taxpayer,
- From one of the taxpayer's storage facilities to another of its storage facilities,
- From the taxpayer's storage facility to its retail sales facility,
- From the taxpayer's retail sales facility to its storage facility, or
- From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

Although handling costs generally must be capitalized, handling costs incurred at a ''retail sales facility'' with respect to property sold to customers at that facility are not required to be capitalized. For example, costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to customers at that facility are not required to be capitalized. Special rules apply to handling costs incurred at ''dual function facilities'' (such as a regional warehouse that also has a sales outlet).

The §263A regulations specifically exclude certain types of costs from the definition of capitalizable handling costs. For example, costs that are associated with delivering a specific good to a specific customer generally are treated as delivery costs, not handling costs, and are not capitalized. This rule does not apply, however, to costs incurred in delivering goods to a related person. Those costs are included in the tax basis of the goods that are sold, and must be accounted for in determining the resulting gain or less from the sale.[24]

Storage costs generally must be capitalized under §263A, unless they are attributable to the operation of an ''on-site storage facility'' located at a retail location.[25]

Service Costs

In addition to capitalizing direct and indirect costs of producing property or acquiring property for resale, §263A requires capitalizing ''service costs'' that are allocable to these activities.[26] For this purpose, a ''service cost'' is a type of indirect cost (such as general and administrative costs) that can be identified specifically with, or that directly benefits or is incurred by reason of, a service department or function. In turn, a ''service department'' is an administrative, service, or support department that incurs service costs. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

Certain service costs must be capitalized (''capitalizable service costs'') while others are not (''deductible service costs''). The distinction lies in whether the particular cost directly benefits or is incurred by reason of the production or acquisition activity, as with ''capitalized service costs.'' Deductible service costs, in contrast, generally are those incurred by reason of the taxpayer's overall management or policy guidance functions, as well as costs incurred by reason of marketing, selling, advertising, and distribution activities.

---

[24] Reg. §1.263A-3(c)(4)(vi).

[25] Reg. §1.263A-3(c)(5).

[26] Reg. §1.263A-1(e)(4).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Capitalizable Service Costs	Deductible Service Costs
Administration and coordination of production or resale activities	Departments responsible for overall management or setting policy for all activities
Personnel operations	Strategic business planning
Purchasing operations	General financial accounting
Materials handling and warehousing and storage operations	General financial planning and financial management
Accounting and data services operations (excluding accounts receivable and customer billing functions)	Personnel policy
Data processing	Quality control policy
Security services	Safety engineering policy
Legal services	Insurance or risk management
	Environmental management policy
	General economic analysis and forecasting
	Internal audit
	Shareholder, public, and industrial relations
	Tax services
	Marketing, selling, or advertising

A third category — mixed service costs — logically includes those that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, the costs of a personnel department may need to be allocated if the department both hires production employees and develops wage, salary, and benefit policies.

The §263A regulations provide a number of alternative methodologies for allocating mixed service costs between production or resale activities (and so capitalized and potentially treated as COGS) and non-production and non-resale activities (and so treated as current expenses).[27] If the taxpayer uses one of several facts-and-circumstances allocation methodologies, the company may choose different methodologies for various types of service costs. This provides the company with an opportunity to optimize the allocation of mixed service costs in connection with BEAT planning considerations. On the other hand, if the taxpayer chooses to allocate mixed service costs using a simplified methodology, that methodology must be applied to all of its mixed service costs, and generally will provide less planning flexibility.[28]

Optional Capitalization

Because of the advantages under the new BEAT rules in classifying costs as COGS rather than as below-the-line deductions, some taxpayers have been exploring the ability to voluntarily capitalize as production costs expenditures that might otherwise be treated as ordinary and necessary business expenses. The ability to voluntarily capitalize expenditures that do not directly benefit or are not incurred by reason of the production of property or the acquisition of property for resale (i.e., period costs) is limited. Under the regulations, the taxpayer may choose to do so only if (i) the method is consistently applied; (ii) is used in computing beginning inventories, ending inventories, and cost of goods sold; and (iii) does not result in a material distortion of the taxpayer's income.

The third requirement — absence of a material distortion of income — may prove problematic where the purpose for capitalizing the period cost is minimizing the taxpayer's BEAT liability. The regulations provide that, for this purpose, a material distortion relates to the source, character, amount, or timing of the cost capitalized, or "any other item affected by the capitalization of the cost." As an example, the regulations posit that a taxpayer may not capitalize a period cost under §263A if doing so would result in a material change in the computation of the taxpayer's foreign tax credit limitation.

In addition, the ability to capitalize period costs under §263A is limited to the types of period costs for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. For example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective

[27] Reg. §1.263A-3(f).

[28] Reg. §1.263A-3(h).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

capitalization, even if the three threshold requirements are otherwise satisfied.[29]

Special Topics

Sales-Based Royalties

The characterization of royalties as either an above-the-line production cost or instead as a below-the-line period cost is of particular importance in the context of the BEAT. As with other indirect costs, the determination centers upon whether the royalty directly benefits or is incurred by reason of either production activities or the acquisition of property for resale. Specifically, in describing licensing and franchise costs required to be capitalized under §263A, the regulations provide:

> Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (such as amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and any royalties that are incurred by a licensee or a franchisee. *These costs include fees, payments, and royalties otherwise described in this paragraph that a taxpayer incurs (within the meaning of section 461) only upon the sale of property produced or acquired for resale*.[30]

The final portion of this provision is particularly noteworthy in the context of BEAT. This rule specifies that so-called "sales-based royalties" must be capitalized if they directly benefit or are incurred by reason of a production activity, even if they become due and payable only upon the ultimate sale of the finished goods. This provision was an effort by Treasury and IRS to modify the treatment of sales-based royalties after the government's Second Circuit loss in *Robinson Knife*.[31] At issue in that case was the application of §263A to a royalty paid by a manufacturer of kitchen goods to the owners of various trade names that the manufacturer embedded into its finished goods. Different trade names were embedded in otherwise identical goods, depending on the intended market and price point for particular items. The taxpayer argued that because the royalty was paid to obtain the use of the intellectual property strictly in connection with the ultimate marketing of the items, §263A was inapplicable. The IRS disagreed, and prevailed in Tax Court.

When the government lost the issue on appeal to the U.S. Court of Appeals for the Second Circuit, it amended the §263A regulations to explicitly state that royalties that directly benefit or are incurred by reason of production or acquisition activities must be capitalized, even if the royalties are incurred or computed only in connection with the sale of the finished goods.

Importantly, however, in amending the regulations, the government also provided that if a taxpayer incurs such a capitalized fee, payment, or royalty only upon the sale of property produced or acquired for resale, the cost may be allocated entirely to property that has been sold — in other words, entirely to the year's cost of goods sold.

This is a crucial point for purposes of BEAT. If the capitalized royalty is incurred only upon the sale of the finished goods — i.e., it is a sales-based royalty — that amount is recovered entirely through cost of goods sold in the year incurred. Practically, this results in there being no timing difference between treating the sales-based royalty as an above-the-line production cost rather than as a below-the-line period cost. Characterizing that capitalized royalty entirely as COGS, however, now produces an unforeseen and obviously unintended benefit for the taxpayer, producing the best of both worlds.

Critically, however, if the taxpayer is not currently classifying a sales-based royalty as cost of goods sold, a Form 3115, *Application for Change in Accounting Method*, is required to update the tax return mapping. Failure to comply with the IRS's published procedures for satisfying the statutory requirement to obtain IRS consent before making *any* change in accounting method can have significant adverse consequences.[32] These may include the assertion of a tax deficiency, interest, and potentially penalties, in addition to the IRS having the ability to place the taxpayer on another, less-favorable accounting method of its choice. Additional details on the procedural requirements are available in the Method Change Considerations section below.

The following simplified examples are illustrative of the planning considerations:

- *Scenario 1:* Manufacturer pays a 10-cents-per-unit royalty to a movie studio for the right to produce action figures based on a hit movie. The royalty is based on the number of units *sold*, and is incurred only upon the sale of the units. Although the royalty is based upon sales, it directly benefits and is incurred by reason of the production of the action figures, and must be treated as a production cost under §263A. Because the royalty is incurred only upon the sale of the manufactured items, the entire amount of royalties incurred during the year is treated as COGS for that year (i.e., recovered immediately to the same extent as if it were a period cost and also treated as COGS for BEAT purposes).

---

[29] Reg. §1.263A-1(j)(2).

[30] Reg. §1.263A-3(e)(3)(ii)(U) (emphasis added).

[31] *Robinson Knife Co. v. Commissioner*, 600 F.3d 121 (2d Cir. 2010), *rev'g* T.C. Memo 2009-9.

[32] §446(e).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- *Scenario 2:* Same as Scenario 1, except that the 10-cents-per-unit royalty is based on each action figure *produced*, regardless of how many are sold, and is incurred upon the production of each unit. Again the royalty is capitalized as a production cost because it directly benefits or is incurred by reason of the production activity. Because it is not incurred only upon the sale of the action figures, however, it is not a ''sales-based royalty'' and is not necessarily included entirely in the manufacturer's COGS that year. The extent to which the capitalized royalty will be recovered as COGS that year will depend on application of the manufacturer's inventory accounting to its facts for that year (e.g., beginning inventory, plus production costs, minus ending inventory).
- *Scenario 3:* Same scenario, except that the manufacturer also pays the movie studio an additional fee for the right to include scenes from the movie in its advertisements for the action figures. Because the additional fee is in the nature of advertising expenditures and was not incurred by reason of the production activity, it is a below-the-line deduction rather than a capitalized cost potentially included in COGS.

	Immediately Recovered	Treated as COGS
Scenario 1	Yes (as COGS)	Yes
Scenario 2	Maybe	Maybe
Scenario 3	Yes (as advertising)	No

Software

Characterizing as COGS amounts paid in connection with software transactions represents another significant focus area in the context of BEAT. In this regard, the distinction between the application of §263A to producers (applicable only to the production of real property or *tangible* personal property) and to resellers (applicable to the production of real property and *any* personal property) requires a careful analysis of the transaction to identify whether a payment represents COGS as opposed to (for example) a license permitting temporary use of the property.

Conceptually, software fits neatly within neither the ''tangible'' nor ''intangible'' categories. This is particularly true as the industry continues to shift away from traditional delivery formats. The distinction between tangible and intangible property is critical for software producers (but not for software resellers, which are subject to §263A for both tangible and intangible property acquired for resale). Despite the somewhat ill-defined nature of software for this purpose, the better view is that software is treated similarly with creative property, such as films, sound recordings, and books. The §263A regulations make clear that the costs of producing creative property is subject to its capitalization requirements regardless whether the items are treated as intangible for other purposes of the tax law.[33] While not entirely free from doubt, software would appear to fall within the same conceptual framework as the other forms of creative property for purposes of COGS.[34]

Boiled down to its basic framework:

- Software sold and delivered to customers on a tangible medium: both producers and resellers have COGS.
- Software made available to customers only in the cloud: neither producers nor resellers have COGS, because the customer is receiving a service rather than property (i.e., SaaS).
- Software is sold and delivered via a download from producer to reseller or sold via download from reseller to consumer: resellers and producers have COGS so long as the transaction is a sale for U.S. federal income tax purposes.

A few points are noteworthy in this regard. First, it is critical that the transactions between either the producer or the reseller and those from whom they are receiving payment constitute sales for federal income tax purposes, rather than licenses for only the temporary use of the software. Although most if not all software transactions are nominally structured as licenses, many non-exclusive, perpetual licenses nonetheless are treated as sales for federal income tax purposes. In those situations, both producers and resellers should be able to treat the direct and indirect costs incurred in connection with the software as capitalized costs under §263A, and as such potentially treated as COGS.

Where the transaction is only a license for tax purposes, however, the transaction will be outside the scope of §263A, and the costs related to the software generally will not be COGS. Instead, costs of developing the software generally will be subject to the general cost recovery rules of Revenue Procedure 2000-50. Costs of purchasing software to be held for license (but not sale) to others generally would be recovered through amortization, rather than as COGS.

Second, certain types of software-related costs will not be treated as COGS regardless of the structure of the transaction. These would include payments to another party for research and development with regard to the produced software, for example.[35]

Finally, in treating software transactions for BEAT purposes as the sale of property rather than as the pro-

---

[33] Reg. §1.263(a)-2(ii).

[34] *See, e.g., Nemetschek N. Am., Inc. v. Commissioner*, T.C. Memo 2001-288 (while not addressing applicability of §263A, concludes that software developed by taxpayer and provided to customers either on a disk or via download is ''merchandise''). *But see* Reg. §1.263(a)-4(c)(2) (treating acquisition of a non-exclusive license for readily available software as the purchase of an intangible).

[35] §263A(c)(2).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

vision of a service, taxpayers should be cognizant of potential state and local tax implications. Those considerations are beyond the intended scope of this discussion, but are an important part of the ''big picture'' in analyzing the scope of COGS for BEAT purposes.

Method Change Considerations

Reclassifying any cost from a below-the-line period cost to an above-the-line production cost potentially treated as COGS constitutes a change in accounting method requiring IRS consent.

Any change in accounting method requires IRS consent through the filing of a Form 3115, *Application to Change Accounting Method*. In most cases, reclassifications such as those discussed here will be eligible for ''automatic consent.''[36] If so, the change requires no user fee; the Form 3115 can be filed up until the date that the taxpayer files its federal tax return for the first year in which it will apply the new treatment (the year of change); and the change can be implemented immediately, without the need for affirmative action by the IRS.

In certain situations, however, automatic consent will not be available. In those situations, the IRS will impose a user fee of approximately $10,000;[37] the Form 3115 must be filed by the last day of the year of change (rather than the extended due date of the return); and the proposed treatment of the costs as COGS may not be implemented until the taxpayer receives written consent from the IRS National Office.[38] Note that the user fee is updated periodically and the most recent user fee scheduled as of the date of this publication is referenced.

A procedural error either in failing to request IRS consent or not requesting consent in the proper manner, can have significant adverse consequences. As such, prior to recharacterizing any item as a production cost, careful attention must be given to the proper procedures for doing so. ''Just doing it'' is not an option.

NON-UNICAP COSTS OF GOODS SOLD

Given the breadth of §263A, the foregoing discussion will apply to the vast majority of costs potentially treated as COGS for purposes of BEAT. In certain situations, however, §263A simply will not apply. As discussed above, for example, costs incurred in producing intangible property fall outside the scope of that provision, as do many construction-related transactions. Nonetheless, because the federal tax system seeks to tax individuals only upon their realized gains rather than upon gross receipts, taxpayers may recover their capital investment in the goods being held for sale prior to being subject to income tax.[39] As such, the taxpayer will have a ''cost of goods sold'' regardless of the application of §263A.

Provisions such as §263(a) provide the relevant guidance in most circumstances. Section 263(a) predates the uniform capitalization rules of §263A, and the regulations under that provision impose the basic requirement that taxpayers must capitalize costs incurred to acquire or produce either tangible property[40] or intangible property.[41] In most regards, §263(a) functions similarly with the uniform capitalization rules discussed above. Direct costs of either producing or acquiring tangible or intangible property must be capitalized.

In addition to direct costs, taxpayers must capitalize costs that ''facilitate'' the production or acquisition of tangible or intangible property. For this purpose, an amount ''facilitates'' the transaction if it is paid in the process of investigating or otherwise pursuing the acquisition.[42]

Certain costs incurred in acquiring tangible property are ''inherently facilitative,'' and therefore always capitalized to the property's tax basis. These include amounts paid for:

- Transporting the property (shipping fees and moving costs);
- Appraisals;
- Negotiating the terms or structure of a transaction and obtaining tax advice on the acquisition
- Application fees, bidding costs, or similar expenses:
- Preparing and reviewing documents that effectuate the acquisition of property (for example, preparing the bid, offer, sales contract, or purchase agreement):
- Examining and evaluating the title to property:
- Obtaining regulatory approval or the acquisition or securing permits related to the acquisition, including application fees;
- Conveying property between the parties, including sales and transfer taxes;
- Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or

[36] *See generally* Rev. Proc. 2018-31.

[37] Rev. Proc. 2018-1.

[38] Rev. Proc. 2015-13.

[39] *Id.*

[40] Reg. §1.263(a)-2.

[41] Reg. §1.263(a)-4(c) (acquired intangibles), §1.263(a)-4(d) (created intangibles).

[42] Reg. §1.263(a)-2(f), §1.263(a)-4(e).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- Services provided by a qualified intermediary or other facilitator of an exchange under §1031.[43]

In the context of producing or acquiring either tangible or intangible property, a number of special rules, exceptions, and safe harbors are potentially applicable. For example, costs incurred for employee compensation, overhead, and ''de minimis'' costs are treated as ''non-facilitative,'' meaning they can be currently expensed rather than treated as capitalized acquisition costs. The taxpayer can elect, however, to capitalize those otherwise deductible costs.[44] As another example, special rules apply to transaction costs incurred to acquire real (but not personal) property.[45]

While these rules tend not to be as complex as those under §263A, they nonetheless contain many pitfalls that must be navigated to correctly distinguish between costs that may be treated as part of the property's tax basis (and that might be recovered as an above-the-line adjustment in computing gross income) and those that are deductible only as below-the-line period costs.

COSTS INCURRED BY TRADITIONAL SERVICE PROVIDERS

By its terms, the concept of ''costs of goods sold'' applies only to the costs of *goods* that are being *sold*. The concept is inapplicable to costs incurred by taxpayers in providing various services to their customers. Instead, those costs generally are deducted as below-the-line operating expenses. The critical distinction is likely to be whether the taxpayer is (or can be) treated as selling merchandise in addition to the provision of its services. If so, the IRS and courts are more likely to permit characterization of some component of the taxpayer's costs as inventoriable costs treated as COGS.[46]

This will be an entirely factual inquiry, with many years of case law available as a (somewhat unpredictable) guide. For example, in the seminal case of *Wilkinson-Beane*,[47] the Tax Court held that while a funeral home was providing a service, it also was selling merchandise — caskets. Among the critical factors supporting the court's conclusion were:

- The taxpayer normally kept an inventory of approximately 35 caskets,
- The caskets were not necessarily used during the year but were purchased and occasionally carried for long periods of time,
- The caskets were on display and played a central role in the ''sale'' of the taxpayer's service, and
- There was a direct relationship between the magnificence of the caskets and the cost of the service.

The court reached the same conclusion in certain cases involving building contractors. For example, in *J.P. Sheahan Associates*,[48] a roofing contractor was required to account for shingles used in roofing repair contracts as merchandise. In reaching this conclusion, the court noted that the roofing materials were separately itemized on the customer's bill; the materials charge represented a significant percentage of the total bill; and the taxpayer imposed a mark-up on the entire bill, including the cost of materials. The court found irrelevant the fact that the taxpayer did not have an ''ending inventory'' of roofing materials on hand at the end of the year.

In *Surtronics*,[49] a taxpayer engaged in electroplating switches and other devices for the electronics industry was required to treat as merchandise the precious metals that it kept on hand for use in its electroplating business. The court concluded, in reliance on *Wilkinson-Beane*, that the taxpayer held the supply of precious metals as merchandise to be sold to customers in connection with its electroplating service.

Similarly in *Thompson Electric*,[50] an electrical contractor was required to treat its supply of wiring, conduits, electrical panels, and lighting fixtures held on hand for small contracts as merchandise. The court principally looked to *Wilkinson-Beane* as support for treating the items as merchandise if the cost of materials the taxpayer uses to provide its service is substantial compared to its receipts.[51] In *Thompson Electric*, the cost of materials varied between 37% and 44% of the taxpayer's cash receipts.

---

[43] Reg. §1.263(a)-2(f)(2)(ii).

[44] Reg. §1.263(a)-2(f)(2)(iv), §1.263(a)-4(e)(4).

[45] Reg. 1.263(a)-2(f)(2)(iii).

[46] Significant developments have occurred in the years following the cases discussed in this section. The IRS announced in Chief Counsel Notice CC-2001-010 (Feb. 9, 2001) that it was suspending litigation of similar cases while it studied this issue. It also provided, in Rev. Proc. 2001-10, a safe harbor for taxpayers having average annual gross income of $1 million or less (recently increased to $25 million as part of the 2017 tax act). Subsequent amendments to Reg. §1.162-3 classify as currently deductible ''materials and supplies'' any items costing $200 or less (among other things), so long as those items are not inventory held for sale. Nonetheless, while most of these cases arose in other contexts and will be factually distinguishable from most BEAT-able transactions, traditional service providers engaged in BEAT planning should consider the principles articulated in these cases to assess whether they are engaged both in providing a service and in selling merchandise, as well as the collateral consequences of such an approach.

[47] *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo 1969-79, *aff'd*, 420 F.2d 352 (1st Cir. 1970).

[48] *J.P. Sheahan Assoc., Inc. v. Commissioner*, T.C. Memo 1992-239.

[49] *Surtronics, Inc. v. Commissioner*, T.C. Memo 1985-277.

[50] *Thompson Elec. v. Commissioner*, T.C. Memo 1995-292.

[51] *See also Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984) (newspapers are merchandise despite ephemeral nature, based on part on the cost of raw materials compared to gross receipts).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

In *Tebarco Mechanical Corp.*,[52] the Tax Court required a mechanical contractor to treat supplies of large piping, duct work, sheet metal, and small pieces of hardware held on-hand in a 3,000-square-foot warehouse for specific contracting jobs as merchandise. The court found on these facts that the contractor was both providing services and selling merchandise.

The Tax Court held in *Von Euw & L.J. Nunes Trucking, Inc*.[53] that a trucking company engaged in transporting sand and gravel made more money from selling sand and gravel than from transporting it. The court found that because the taxpayer could earn a profit exclusively from transporting the sand and gravel, it was not ''an indispensable and inseparable part of providing the service.'' The court also placed weight on the fact that the taxpayer did not consume, alter, or add to the sand, and that as a result, it did not lose its separate identity through the performance of the service. As such, receipts from the sand and gravel were required to be treated as arising from the sale of merchandise.

A company engaged in the custom printing of calendars, napkins, greeting cards, and forms according to the specifications of customers, and who ordered paper stock and other materials only as required for specific orders, was engaged in the production and sale of merchandise.[54]

Similar companies, however, have been found not to be selling merchandise when the construction materials were consumed by the taxpayer in performing the service. In *Galedrige*,[55] for example, the Tax Court held that a paving contractor was not required to treat emulsified asphalt as merchandise sold to customers. The court agreed with the taxpayer that its customers hired it for its expertise in paving. The provision of the asphalt was ''an inseparable and indispensable part of that service,'' and the asphalt lost its separate identity through the performance of the service.

Further, noting that the asphalt hardened and became worthless within two to five hours, the court relied in part upon the ''ephemeral'' character of the asphalt to distinguish it from the roofing materials, electrical materials, and precious metals previously held to be merchandise. In addition, the *Galedrige* court found that the variable having the greatest impact upon a project's price was the complexity of the client's site as well as the additional labor and machinery that would be required, rather than the ''magnificence'' of the materials. The court reached the same conclusion for another asphalt contractor in *Jim Turin & Sons*,[56] a cement contractor in *RACMP Enterprises*,[57] and a custom-flooring contractor in *Smith*.[58]

In *Osteopathic Medical Oncology*,[59] the Tax Court declined to make a health care provider bifurcate its receipts between services and merchandise. Instead, the court found that the drugs administered to patients during chemotherapy treatments are not merchandise. In distinguishing the chemotherapy provider from the funeral home in *Wilkinson-Beane*, the Tax Court stated:

> Petitioner kept no more than a 2-week supply of chemotherapy drugs on hand and used virtually all the drugs during the taxable year. The drugs also were not displayed to patients for selection, and patients played no role in determining the type or amount of drugs used on them. Furthermore, unlike the taxpayer's business in *Wilkinson-Beane, Inc.*, the type of chemotherapy drugs or the ''magnificence'' thereof played no role in whether patients chose to purchase petitioner's services. The variable factor in the cost of a patient's treatment is a factor out of the patient's control; i.e., the type and severity of the patient's condition. We also find it critical that a person is unable to obtain the chemotherapy drugs without purchasing petitioner's service. We find nothing in the case of *Wilkinson-Beane, Inc.* that would cause us to believe that the taxpayer's services there depended on the purchase of caskets from it. Instead, the taxpayer in *Wilkinson-Beane, Inc.*, by choice, sold the funeral services and caskets as a package.

As in *RACMP*, the fact that the drugs were an inseparable and indispensable component of the service and lost their separate identity during the performance of the service, appeared to be determinative.

Finally, a supply of ''rotable spare parts'' kept on hand by a service provider to facilitate the efficient repair of customers' equipment generally is not treated as merchandise held for sale. Instead, those parts are treated as depreciable fixed assets used in the taxpayer's service business. For example, when a computer repair service keeps on hand a supply of spare parts that can be quickly swapped out with identical faulty components in repairing a customer's computer, the service provider generally is not treated as ''selling''

[52] *Tebarco Mech. Corp. v. Commissioner*, T.C. Memo 1997-311.

[53] *Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner*, T.C. Memo 2000-114.

[54] *Golden Gate Litho v. Commissioner*, T.C. Memo 1998-184.

[55] *Galedrige Constr. v. Commissioner*, T.C. Memo 1997-240.

[56] *Jim Turin & Sons, Inc. v. Commissioner*, T.C. Memo 1998-223, *aff'd*, 219 F.3d 1103 (9th Cir. 2000).

[57] *RACMP Enters. v. Commissioner*, 114 T.C. 211 (2000).

[58] *Smith v. Commissioner*, T.C. Memo 2000-353.

[59] *Osteopathic Med. Oncology & Hematology, P.C. v. Commissioner*, 113 T.C. 376 (1999), *acq.* AOD 2000-05. *See also Mid-Del Therapeutic Ctr. v. Commissioner*, T.C. Memo 2000-130, *aff'd*, 2002 U.S. App. LEXIS 2713 (10th Cir. 2002).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

the spare parts (and as such would not have COGS related to the transaction).[60]

CONSIDER THE BEAT-ABILITY OF COSTS

This line of cases, while perhaps not altogether applicable to many cross-border transactions, nonetheless provides a useful guidepost for considering whether some portion of an erstwhile service provider's gross receipts in fact arises from the sale of merchandise. If so, it may be worthwhile to consider the extent to which some portion of the taxpayer's expenditures for the year are properly characterized as costs of goods sold related to the production or acquisition of that merchandise. The potential BEAT benefit should be weighed against other potential ramifications, particularly those in the state and local tax arena.

---

[60] *Hewlett-Packard Co. v. United States*, 71 F.3d 398 (Fed. Cir. 1995), *rev'g Apollo Computer, Inc. v. United States*, 32 Fed. Cl. 334 (1994); *Honeywell, Inc. and Subs. v. Commissioner*, T.C. Memo 1992-453, *aff'd*, 27 F.3d 571 (8th Cir. 1994). The IRS announced in Rev. Rul. 2003-37 that it would follow these decisions.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

The Ins and Outs of Domestication of Foreign Trusts

By Jennifer J. Wioncek[*]

Trusts are a classic planning tool for the transfer of a family's wealth down to future generations. Cross-border families will often consider establishing a trust governed by local law or outside of the United States if the matriarch or patriarch is not a U.S. resident (i.e., is not a U.S. taxpayer). However, if any of the current or future beneficiaries are, or will become, a U.S. taxpayer (''U.S. beneficiary''), a foreign trust will create additional tax complexity for such beneficiary at some point. In the past few years, there also has been a push to consider the United States as a place to govern trusts where no beneficiary is expected to be a U.S. beneficiary. This is largely driven by the OECD's implementation of the Common Reporting Standard (''CRS''), under which jurisdictions agree to exchange financial account information with each other in an effort to combat offshore tax evasion. Almost 100 jurisdictions[1] have agreed to participate in CRS but, as of the date of this article, the United States continues to be a non-participating jurisdiction, resulting in a number of trusts either being established in or transitioned to the United States. In this article, I will discuss some of the tax, planning, and practical issues involved in considering the domestication of foreign trust structures.

THE BASICS

Practitioners need to have a basic understanding of the following key concepts in order to understand the specific tax and planning issues discussed in this article.

Residency Rules and Taxation of Individuals

For purposes of this article, a U.S. beneficiary is an individual who is a U.S. person for purposes of both U.S. federal income tax and U.S. federal gift/estate/generation-skipping transfer tax. For U.S. federal income tax purposes, an individual is a U.S. person if he or she is either a citizen of the United States (''U.S. citizen'') or a resident alien of the United States (''U.S. income tax resident'').[2] A resident alien is generally an individual who either has been granted the lawful right to reside permanently in the United States and whose status as such has not been revoked (i.e., a green card holder)[3] or someone who has satisfied the ''substantial presence test.''[4] A person who is neither a U.S. citizen nor a U.S. income tax resident (and has not elected to become a U.S. income tax resident) is treated for purposes of this article as a non-U.S. person.[5]

The term ''resident'' in the transfer tax context is different from the definition of ''resident'' in the income tax context. ''U.S. resident'' in the transfer tax context means a U.S. citizen, or a person who is domiciled in the United States at the time of his or her death or at the time of making the gift (''U.S. domiciliary''). Whether a person is a U.S. domiciliary depends on the person's intent.[6] To be domiciled in a country is to live there with no definite present intent of leaving.[7] It is possible for someone to be classified as a U.S. income tax resident, and be subject to tax in

[*] Jennifer J. Wioncek is a partner with Bilzin Sumberg Baena Price & Axelrod LLP in Miami, and an adjunct law professor at University of Miami School of Law's Tax LLM Program. She would like to thank her partner, Hal J. Webb, for his valuable input in review and comment on this article.

[1] As of January 15, 2018, 98 countries have signed the Multilateral Competent Authority Agreement. *See* OECD Automatic Exchange Portal website.

[2] §7701(a)(30)(A). Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 (''Code''), or the Treasury Regulations thereunder, both as amended through the date of this article. All references to U.S. federal taxes herein are references to federal taxes, unless otherwise specified.

[3] §7701(b)(6)(A).

[4] An individual meets the substantial presence test by being physically present in the United States for at least 183 days under the statutory formula test, which counts the number of days physically present in the United States during the current year and looks back at the number of days physically present in the United States in the prior two years. In fact, if an individual is physically present in the United States for no more than 121 days every year, the individual will not meet the substantial presence test and will be classified as a nonresident alien. Certain days of presence in the United States do not count for purposes of this test. The three-year look-back does not apply unless the individual is physically present in the United States for 31 days in the current year, and the total number of days in which the individual is present in the current year plus the two prior years equals or exceeds 183. To determine if the 183-day count is satisfied within the three-year look-back, a separate multiplier is applied to each year in the three-year period. For the current year, the multiplier is 1 and each day is counted as a full day. For the immediately preceding calendar year, the multiplier is ⅓ (e.g., 60 days in the United States × ⅓ = 20 days). For the next preceding calendar year, the multiplier is ⅙ (e.g., 60 days in the United States × ⅙ = 10 days). Thus, during either of the two preceding calendar years, even if the individual was physically present in the United States for at least 183 days, the taxpayer may not be deemed a U.S. resident alien for the current tax year.

[5] §7701(b)(1)(B).

[6] Reg. §20.0-1(b).

[7] Reg. §20.0-1(b), §25.2501-1(b).

Tax Management International Journal
© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

the United States on his or her worldwide income, but be classified as a nonresident of the United States for transfer tax purposes. Determining domicile for transfer tax purposes is fact-specific,[8] none of which is determinative.

Of course in the terms of taxation, the residency of the settlor and/or beneficiaries of the trust could make a big difference in the overall planning strategies for a particular client. U.S. citizens and U.S. income tax residents are taxed on their worldwide income, as opposed to non-U.S. persons only being taxed on certain types of U.S.-source income. Similarly, the estates of U.S. citizens and U.S. domiciliaries are subject to U.S. federal transfer taxes on the transfer of their worldwide assets.[9] The estate of a person who is neither a U.S. citizen nor a U.S. domiciliary is subject to U.S. federal estate tax only with regard to the decedent's assets which were situated within the United States upon his or her death (i.e., real estate located in the United States, stock in a domestic corporation [meaning a corporation created or organized in the United States or under the law of the United States or of any State] and personal property located in the United States).[10]

Most importantly in the transfer tax context, unlike U.S. citizens and U.S. domiciliaries, the estate of a person who is neither a U.S. citizen nor a U.S. domiciliary is allowed only a $13,000 estate tax credit, which is equivalent to an estate tax exemption amount of $60,000 of U.S.-situs assets.[11] This was not changed by the recent U.S. tax reform act,[12] which significantly increased the exclusion amount for U.S. citizens and U.S. domiciliaries to approximately $11.18 million.[13] A person who is neither a U.S. citizen nor a U.S. domiciliary is subject to U.S. federal gift tax only with regard to inter vivos transfers of real estate and tangible personal property which are situated within the United States.[14] U.S. federal gift tax is generally not imposed with regard to inter vivos transfers of intangible property, such as shares of stock.[15]

Taxation of Domestic Trusts vs. Foreign Trusts and Their Beneficiaries

In determining the proper taxation of any trust and/or its beneficiaries, I would always teach my Subchapter J students that there are some initial questions that need to be first answered:

- Is the trust domestic or foreign?
- Is the trust a grantor trust or a non-grantor trust
- If a grantor trust, is the grantor a U.S. person or a non-U.S. person?

A domestic trust is any trust for which (i) one or more U.S. persons have the authority to control all substantial decisions of the trust (''control test'') *and* (ii) a court within the United States is able to exercise primary supervision over the administration of the trust (''court test'').[16]

A foreign trust is any trust which is not a domestic trust.[17] Thus, a trust can be governed, supervised, and administered by and under the laws of a state of the United States and still be considered a foreign trust if a substantial decision can be controlled by a person who is not a U.S. person. A ''substantial decision'' includes, but is not limited to: (a) decisions concerning whether and when to distribute income or corpus; (b) the amount of any distributions; (c) the selection of a beneficiary; (d) whether a receipt is allocable to income or principal; (e) whether to terminate the trust; (f) whether to compromise, arbitrate, or abandon claims of the trust; (g) whether to sue on behalf of the trust or to defend suits against the trust; (h) whether to remove, add, or replace a trustee; (i) whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee (even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa); and (j) investment deci-

---

[8] Some factors on which the IRS and courts have focused are: (i) the length of time spent in the United States and abroad and the amount of travel to and from the United States and between other countries; (ii) the value, size, and locations of the individual's homes and whether he owned or rented them; (iii) whether the individual spends time in a place due to poor health, for pleasure, to avoid political problems in another country, etc.; (iv) the location of valuable or meaningful tangible personal property; (v) the location of the individual's family and close friends; (vi) the location of the individual's religious and social affiliations or participation in civic affairs; (vii) the location of the individual's business interests; (viii) visa status; (ix) the places where the individual states that he resides in legal documents; (x) the jurisdiction where the individual is registered to vote; (xi) the jurisdiction that issued the individual's driver's license; and (xii) the individual's income tax filing status. *See Estate of Valentine v. Commissioner*, 21 B.T.A. 197 (1930), *acq.* X-1 C.B. 4, 67; *Jellinek v. Commissioner*, 36 T.C. 826 (1961), *acq.* 1964-1 C.B. 4; *Estate of Bloch-Sulzberger*, 6 T.C.M. 1201, 1203 (1974); *Estate of Nienhuys*, 17 T.C. 1149, 1159 (1952); *Estate of Paquette*, T.C. Memo 1983-571.

[9] §2001, §2031.

[10] §2101, §2103, §2104.

[11] §2102(b).

[12] Pub. L. No. 115-97.

[13] §2010(c)(3).

[14] §2511(a).

[15] §2501(a)(2).

[16] §7701(a)(30)(E).

[17] §7701(a)(31)(B).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

sions. However, if a U.S. person under §7701(a)(30) hires an investment advisor for the trust, investment decisions made by the advisor will be considered substantial decisions controlled by the U.S. person if the U.S. person can terminate at will such advisor's decision-making power.[18]

A grantor trust is a trust for which a person (such as the grantor) is treated as the owner of the income and assets of the trust for U.S. federal income tax purposes.[19] While and to the extent that the grantor (or other person) is treated as the owner of the assets of a trust for U.S. federal income tax purposes, no distribution from such trust made to any person (including a U.S. beneficiary) would constitute taxable income to such person for U.S. federal income tax purposes because the grantor (or other person) will be deemed to have earned all of the income of such trust.[20]

A trust established by a grantor who is a U.S. person is generally a grantor trust if the grantor retains certain rights or holds certain powers described in §673–§679. The types of powers and rights that can cause grantor trust status is broad, and, therefore, it is fairly easy to design a grantor trust for a U.S. person as opposed to a non-grantor trust. By comparison, there are limited ways to structure a grantor trust established by a grantor who is a non-U.S. person. This is because §672(f)(1) provides that the grantor trust rules apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a U.S. income tax resident or a domestic corporation. The rationale is to limit the opportunities for the deferral of U.S. federal income taxation for trusts set up by non-U.S. persons in low- or no-tax jurisdictions in a way that the U.S. beneficiaries can receive distributions from the trust on a tax-free basis.

Notwithstanding the limitation under §672(f)(1), there are really only two options for structuring a grantor trust by a non-U.S. person.[21] The first option provides for a situation where the non-U.S. person who establishes the trust has the power to revest absolutely in himself/herself title to the trust property to which such portion is attributable and such power is exercisable solely by such non-U.S. person without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor.[22] If the trust fails to qualify for this exception in any particular year, it may not qualify in any subsequent year, even if the requirements otherwise would be satisfied.[23]

The second exception involves a situation where the only amounts distributable from such portion of the trust (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.[24] The Treasury Regulations and preamble to the regulations suggest a very restrictive interpretation of this exception. The exception does not apply if there is any potential way that someone other than the grantor and/or the grantor's spouse could benefit from the trust during the grantor's lifetime even if temporarily and even if such other person never receives an actual distribution from the trust.[25]

With a grantor trust, the trust is not a taxpayer. Instead, the U.S. federal income tax residency status of the grantor will dictate how the trust's income is taxed, and whether it is taxed in the United States at all. This is true regardless whether the trust is classified as a domestic or a foreign trust. If the grantor is a U.S. person, the grantor will be taxed on the worldwide income earned by the trust. If the grantor is a non-U.S. person, the grantor will be generally taxed only on the trust's taxable U.S.-source income (which tax may be payable in the form of withholding at the source).

A trust is a non-grantor trust to the extent it is not a grantor trust.[26] A non-grantor trust is treated as owning its own assets for U.S. federal income tax purposes rather than having ownership of its assets attributed to another person. Non-grantor trusts calculate their taxable income in the same manner as individuals with certain modifications set forth in §642, §643, §651, and §661. For this purpose, a domestic non-grantor trust is subject to tax on its worldwide income. By comparison, foreign non-grantor trusts are treated as nonresident individuals who are not present in the United States at any time.[27] When the grantor dies, the trust's grantor trust status generally ceases

[18] Reg. §301.7701-7(d)(1)(ii).

[19] §671; Reg. §1.671-1(a).

[20] Rev. Rul. 85-13.

[21] In addition to these exceptions, certain trusts in existence on September 19, 1995, are not subject to the §672(f) limitation: those treated as owned by the grantor under §676 (powers to revoke and revest) or §677 (income paid to or accumulated for the benefit of the grantor or the grantor's spouse). Reg. §1.672(f)-3(a)(3), §1.672(f)-3(b)(3). Section 672(f) will apply, however, with regard to any portion of the trust attributable to transfers to the trust made after September 19, 1995. Reg. §1.672(f)-3(d).

[22] §672(f)(2)(A)(i).

[23] Reg. §1.672(f)-3(a)(1).

[24] §672(f)(2)(A)(ii).

[25] Reg. §1.672(f)-3(b)(4) *Ex.* 3.

[26] Non-grantor trusts are further classified as either "simple" trusts or "complex" trusts. The term "simple trust" refers to a non-grantor trust that is not permitted to make payments to charity and that, in the year for which the characterization is made, makes no principal distributions. §652(a). A "complex" trust is any trust that is not a simple trust. §662.

[27] §641(b), §871(a)(2).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

and the trust automatically converts to a non-grantor trust.

Depending on the distribution provisions, a non-grantor trust's income is typically taxed at the trust level, unless the trust's income for the year is distributed out to a beneficiary and taxed at the beneficiary level.[28] A beneficiary who is a U.S. person will include in income the entire distribution limited to his or her pro rata share of the trust's ''distributable net income'' (DNI) for the taxable year (discussed further below) even if the entire make-up of the trust's DNI is from foreign sources. On the other hand, a beneficiary who is a non-U.S. person will include his or her pro rata share of only the taxable U.S.-source income included in DNI (the applicable U.S. taxes, which the trustee may be required to withhold if it is not otherwise withheld at the source).

In the context of foreign trusts, there is an additional set of rules that apply when considering the U.S. federal income tax consequences to U.S. beneficiaries. U.S beneficiaries of a foreign non-grantor ''complex'' trust become subject to the ''throwback tax'' rules which generally do not apply to domestic non-grantor trusts.[29] A distribution of DNI from a foreign non-grantor trust to a U.S. beneficiary is taxable to the U.S. beneficiary regardless of whether the items that make up DNI are from U.S. or foreign sources.[30] The items that make up DNI retain their tax character. Unlike for domestic non-grantor trusts, however, the definition of DNI includes capital gains for foreign trusts.[31]

The income retained by the foreign non-grantor trust from a year in which all current DNI was not distributed is UNI.[32] Under §665(a), UNI is defined as the amount by which the DNI of the trust exceeds the sum of 1) the amount of income required to be distributed currently, 2) amounts properly paid or credited or required to be distributed, and 3) the amount of taxes imposed on the trust attributable to the DNI.

If a foreign non-grantor trust makes a distribution to a U.S. beneficiary in any year in excess of that year's DNI, the excess is called an ''accumulation distribution.'' The throwback tax rules provide an ordering rule as to what type of income comes out of the foreign trust first. A distribution first will carry out any DNI from the current year, with such excess amount distributed carrying out UNI accumulated in prior years, and with any further excess amount distributed being treated as a tax-free distribution of principal.[33] In other words, only when all UNI has been completely distributed out of the trust can any portion of a distribution be considered a tax-free distribution of principal.

If a foreign non-grantor trust issues a distribution which exceeds its DNI in a given year, the U.S. beneficiaries to whom such distribution is made must include the DNI portion of the distribution in their gross income with the UNI portion being subject to tax under the ''throwback rule.'' The throwback rule is intended to impose the tax that would have been paid if the trust had made distributions in the years the income was earned, and it applies only where the trust has made an accumulation distribution. However, since capital gains are included in DNI for a foreign non-grantor trust, once they are accumulated they lose their preferential tax treatment under the throwback tax calculation.

Furthermore, under §668(a)(1), an accumulation distribution made by a foreign non-grantor trust to a U.S. beneficiary triggers a special ''interest charge.'' The interest is calculated as if the income was distributed in the year it was earned and the tax owed from the distribution was delayed.[34] Interest calculated under this method cannot exceed the amount of the accumulation distribution but can be so punitive that it can reach the full amount of the distribution, thereby having the effect of confiscating the distribution from the U.S. beneficiary. Furthermore, this interest charge is not deductible for income tax purposes.[35]

MEANING AND MECHANICS OF 'DOMESTICATION'

Meaning

''Domestication'' is not defined in the Internal Revenue Code. It is a concept that generally refers to ei-

[28] §651, §652, §661, §662.

[29] §665(c).

[30] §643(a)(6).

[31] *Id.*

[32] An accumulation distribution is deemed distributed on the last day of each preceding taxable year starting with the earliest year. §666. In the context of allocating UNI over multiple years, UNI allocated to the earliest year reduces the UNI available to the next earliest year and so forth. In addition, the portion of UNI allocated to a particular prior year is increased for a deemed distribution of the taxes that would have been paid by the trust on the accumulated income. §666(c). The effect of this is to increase the interest charge. A detailed discussion of the method for calculating the relevant tax and interest charges applicable to an accumulation distribution is beyond the scope of this article.

[33] However, if during any taxable year the trust's ''fiduciary accounting income'' (as described under §643(b)) exceeds the trust's DNI, the portion of the distribution to the U.S. beneficiary that does not exceed ''fiduciary accounting income'' will be treated as a tax-free distribution. §665(b) (flush language).

[34] This charge is the amount of interest which would be determined on the partial tax computed under §667(b) for a designated period, using rates and methods applicable to underpayment of tax under §6621.

[35] §668(c).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

ther having a foreign trust's assets decanted (or appointed) to a domestic trust, or changing the classification of a foreign trust to a domestic trust. This type of change in classification typically involves changing the governing law of the trust and replacing the foreign trustee with a U.S. person as trustee. However, if the trust is already governed by the laws of a jurisdiction in the United States and the trusteeship is already controlled by one or more U.S. persons, then such change in classification would likely involve foreign persons releasing powers over the trust which caused the trust to be classified as a foreign trust. Which method is used and the planning involved depends on the terms of the foreign trust, the application of the governing law of the trust, the situs and nature of the assets of the trust, the global tax issues involved and the preferences of the parties involved (i.e., the existing and new trustees, the settlor, the beneficiaries, protector, and certain other powerholders).

Mechanics

Decanting

The mechanics of decanting require in most cases the actual establishment of a new domestic trust governed under a U.S. state law with a U.S. person serving as trustee. Sometimes, however, the receiving domestic trust is set up at the same time as the foreign trust and minimally funded, in order to (among other reasons) reduce the time involved later when the assets are ready to be appointed (most likely after the foreign trust ceases to be treated as a grantor trust).

Decanting has to be a permissible power under either the terms of the foreign trust instrument or the foreign trust's governing law. If it is not permissible, the transfer/appointment of the assets to the new domestic trust could be ineffective, losing the benefit of any U.S. tax savings associated with such appointment. Engaging foreign counsel in the foreign trust's jurisdiction is advisable.

It is common for foreign trustees to prepare a deed/instrument of appointment and resignation to achieve the decanting. If not mandated in the foreign trust instrument (which is rare), best practices would dictate that the decision to decant should be that of an independent foreign trustee, or upon the direction of an independent protector. It is generally advised that the U.S. beneficiaries not provide consent to this appointment or have meaningful input in the provisions of the new trust or the overall process. This approach should avoid any positions concerning constructive receipt or a general power of appointment, each of which could lead to adverse U.S. federal income, gift and estate tax consequences.

In addition to making sure that the new trust is established under a U.S. state's law and would be administered primarily in the United States, the new trustee needs to be a U.S. person (or, if more than one person will serve as trustee, then a majority of the trustees who have control over all substantial decisions must be U.S. persons) if the intent is to qualify as a domestic trust. Furthermore, the new trust instrument needs to be carefully drafted to avoid having a non-U.S. person having control over one or more substantial decisions of the new domestic trust.

Since a decanting involves the transfer/appointment of assets from one trust to another, there needs to be proper re-titling of trust assets. Typically, the foreign trustee will ask the new U.S. trustee for an indemnity against the appointed assets for any prior liabilities of the foreign trustee. The re-titling and indemnity process can be time-intensive, and the terms of the indemnification may need to be negotiated.

In preparation of the new trust instrument, maintaining certain provisions of the foreign trust instrument may be required either because it is within the settlor's original intent or because it is required by the terms of the foreign trust instrument — or to prevent certain U.S. tax consequences related to the beneficiaries (e.g., general power of appointment). A key provision to be reviewed and considered is the foreign trust's termination period (i.e., perpetuity period). If the foreign trust has a specific perpetuity period, such period will attach to the appointed trust assets. If the original period is not maintained by the new domestic trust with regard to the appointed assets, it could result in an ineffective transfer. This can happen if the new trust is established in a U.S. state that has a longer perpetuity period than the foreign trust, or has completely abolished its perpetuity rules (e.g., Delaware).

The new domestic trust needs to meet the requirements for establishing a valid trust under the applicable U.S. state law. In general, a valid trust is created when a competent settlor transfers property to the trustee for the benefit of identifiable beneficiaries. Unlike many foreign trust law jurisdictions where a valid trust can be established by being declared by the trustee without receipt of any transfer of assets, most U.S. state laws require either a named settlor who transfers cash or assets to the named trustee or the settlor declaring the trust and acting as trustee over the trust assets.[36] For U.S. federal income tax purposes, though, the grantor of the domestic trust will be the grantor of the foreign trust over that portion of the assets appointed, even if the grantor of the foreign trust is no longer alive.[37] In setting up the domestic trust, the named settlor could be the settlor of the foreign

[36] *See, e.g.,* Fla. Stat. §736.0401.

[37] *See* Reg. §1.671-2(e)(5).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

trust (if still alive or in existence), the foreign trustee, the new U.S. trustee, or another person. It is generally not recommended that a U.S. beneficiary of the foreign trust serve as the named settlor, to avoid any confusion later that the assets of the trust should be included in the U.S. beneficiary's gross estate under §2036.

Migration

Changing the situs of a foreign trust is also referred to as migration. It is analogous to changing the domicile of a foreign company except that there are generally no specific U.S. state law requirements because most common law trusts are not registered with the state like companies are.

In a typical situation, migration requires an instrument to be prepared whereby the foreign trust's governing law is changed to the selected U.S. state law and the foreign trustee resigns and a new U.S. trustee is appointed if, again, the intent is for the trust to be classified as a domestic trust. Unlike with a decanting, a new trust is not established because the foreign trust is considered to ''continue'' as the same trust but for the change of law, trustee, and/or power holder. In some cases, though, the trust instrument may need to be amended or powers may need to be released to conform to the new governing law of the trust or to adhere to the requirements of being classified as a domestic trust (i.e., removing and replacing all non-U.S. persons with one or more U.S. persons for all substantial decisions of the trust to satisfy the control test).

Like with a decanting, there will be a re-titling of the trust assets between the foreign trustee and the new U.S. trustee. Further, the foreign trustee will likely also require an indemnification by the U.S. trustee.

REASONS FOR AND AGAINST DOMESTICATION

Reasons in Favor

The following is a non-exhaustive list of tax and non-tax reasons in favor of domesticating a foreign trust:

To Minimize Application of Throwback Tax Rules to U.S. Beneficiaries

Typically, designing trust structures as grantor trusts established by a non-U.S. person can have numerous U.S. federal income tax advantages for the U.S. beneficiaries of such trusts. However, grantor trust status ceases upon the non-U.S. person's death (sometimes earlier), at which time the U.S. federal income tax advantages for the U.S. beneficiaries also cease and the throwback rules discussed above can begin to apply. If all of the beneficiaries are U.S. persons and there is no reason to keep the trust outside of the United States, the most often used strategy to minimize the application of the throwback tax rules is to domesticate the trust and have it be classified as a domestic trust. This is because it removes the application of the throwback rules on future accumulated income.[38] While one UNI reduction planning strategy is to annually distribute all of the DNI to a U.S. beneficiary, this approach could eventually trigger a higher U.S. federal estate tax liability for a U.S. beneficiary's gross estate if such annually distributed income is not exhausted by the time of the U.S. beneficiary's death. If the trust is domesticated, its DNI can accumulate and the wealth generated inside of the trust can be protected from U.S. federal estate tax exposure on the death of the U.S. beneficiary.

Reduce Compliance Issues for U.S. Beneficiaries

Foreign trusts can generate a heavy compliance burden on U.S. persons who derive benefits therefrom. There are various federal reporting requirements for U.S. persons who establish a foreign trust, and U.S. beneficiaries of a foreign trust. These requirements include but are not limited to:

(a) FinCen Form 114 (formerly known as ''FBAR'');

(b) Form 3520/Form 3520-A;

(c) Form 8938; and

(d) Schedule B to Form 1040.

And they do not apply if the trust is a domestic trust. In addition to cost savings to the U.S. settlor and/or U.S. beneficiary in preparation of their annual U.S. federal tax return, there is also a benefit of saving the time to gather and review the information needed for these forms. There also would be the benefit of not having to incur the time and stress of making sure everything is filed correctly and on time, and less risk of penalties if an error is made (even if it is an error made in good faith). Finally, there may be less risk of an audit because these forms most likely create a higher profile for the U.S. settlor or U.S. beneficiary within the IRS than a domestic trust would.

Reduce Compliance Burden on Foreign Trust

A foreign trust being administered outside of the United States will have to comply with the requirements of the Foreign Account Tax Compliance Act (FATCA). With CRS and other transparency-related disclosure rules being implemented across the world, foreign trusts incur additional compliance burdens that will call for the engagement of a professional ad-

[38] §665(c).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

viser to deal with properly. Most of these compliance burdens would not apply if the trust is a domestic trust.

Foreign trustees do not generally prepare annual trust accountings, or, if they do so, they typically do not follow U.S. federal tax principles. It can be a costly exercise to utilize a foreign trustee's bank and financial records to calculate DNI each year so that a U.S. beneficiary can properly prepare his or her tax return. In some cases, foreign financial institutions for an additional cost produce a ''draft'' Form 1099 even though such form would not be filed with the IRS. Even though this can be a good tool for the U.S. beneficiary to later track a foreign trust's income, it can also create confusion for the IRS because the IRS cannot match the information on the return with any information that it already has in its system.

The above-described compliance costs will in turn lead to either higher trust administration costs or higher professional fees. Moving a foreign trust to the United States could reduce these compliance burdens and save money for the ultimate benefit of the beneficiaries.

Tax Credit Issues

The application of the foreign tax credit rules to U.S. beneficiaries who receive distributions from a foreign non-grantor trust are not clear and are difficult to apply. Section 901(b)(5) indicates that a beneficiary may receive a credit (subject to §904 limitations) on his or her ''proportionate share of the taxes'' paid or accrued to a foreign country. However, there is nothing explicit in the Code regarding the application of foreign taxes paid by a foreign non-grantor trust with respect to distributions of current year income (i.e., DNI) to a U.S. beneficiary from a foreign nongrantor trust. Also, there is nothing explicit as to how to apply the foreign tax credit. By comparison, the throwback rules provide that a U.S. beneficiary's accumulation distribution is grossed up by the foreign taxes paid on foreign-source income related to the UNI deemed distributed.[39] A U.S. beneficiary would then be entitled to a foreign tax credit for such foreign taxes paid.[40] Most practitioners follow the same principles for current-year income distributions.[41]

In theory, the Code allows a foreign non-grantor trust to claim a foreign tax credit against its U.S. tax liability.[42] However, it is highly unlikely that there would be U.S. tax liability against which to claim a foreign tax credit, because the foreign-source income of a foreign person — including a foreign trust — generally is not subject to U.S. federal income taxation.

A foreign non-grantor trust may have also had U.S. withholding taxes applied on the trust's U.S.-source income. The conduit tax principles of the taxation of trusts would be violated if the U.S. beneficiary who receives a distribution from a foreign non-grantor trust would not be allowed to receive a credit for such U.S. withholding taxes paid by the trust. Thus, a U.S. beneficiary would similarly gross up its distribution for its pro rata share of U.S. withholding taxes paid.[43] From a practical standpoint, foreign financial institutions typically cannot substantiate and prove the exact amount of U.S. withholding tax on Form 1042, which puts the U.S. tax credit at risk from being able to be claimed by a U.S. beneficiary.

If the foreign trust is domesticated, the complexities of the foreign tax rules would be reduced — or even eliminated entirely if the domestic trust invested in all U.S. financial assets. Further, if all of the money managers are located in the United States, then each of them would be required to issue a Form 1099 each year and each of those forms would be filed electronically with the IRS. There also would be no issues with regard to U.S. withholding tax. The IRS could easily match those electronically filed Forms 1099 and U.S. tax withheld with the proposed new domestic trust's federal income tax return.

Investment Considerations

If the assets of a foreign non-grantor trust with U.S. beneficiaries were managed in the United States, a U.S. money manager likely would be much more sensitive to U.S. tax-efficient investing than an investment manager outside the United States, and would be more likely to have specific strategies available for U.S. tax-efficient investing. For example, money managers located outside the United States may not be able to sell tax-free municipal bonds (bonds of municipalities located within the United States).

A foreign non-grantor trust that invests in U.S. stocks would be subject to U.S. withholding tax at a 30% tax rate (subject to the application of a treaty which is rare in most foreign trust structures). If the trust were a domestic trust, it would be eligible for the lower qualified dividends tax rate of 20% (plus 3.8% Medicare tax). While U.S. beneficiaries of a foreign non-grantor trust may have the ability to offset their

[39] §666(b), §667(a).

[40] §667(d).

[41] *See also* GCM 36304 (1975) (''a United States beneficiary of a foreign trust could credit those foreign income taxes paid or accrued by the trust and attributable to certain foreign-source income of the trust that was included in the beneficiary's gross income under the predecessor of Code §662(a)(2)'').

[42] §642(a).

[43] Reg. §1.1441-3(f), §1.1462-1(b).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

U.S. federal income tax liability for their pro rata share of U.S. withholding taxes related to pro rata share of DNI distributed, this can increase the accounting complexities with respect to their U.S. federal tax return. As such, if the portfolio is highly invested in U.S. stocks, the trust could be more tax- and administratively efficient as a domestic non-grantor trust.

Foreign trusts are generally invested in assets valued and taxed in one or more currencies other than U.S. dollars. The conversion from U.S. dollars to another currency and vice versa creates tax complexities and reporting uncertainties from a U.S. federal tax point of view (as to whether there is a currency gain or loss, whether the amount of gain or loss should be converted to U.S. dollars on the date of sale and purchase, and what exchange rate should be used). Furthermore, a foreign trust could be unnecessarily exposed to currency risks if the beneficiaries will spend their money only or primarily in U.S. dollars.

Other Non-Tax Considerations

With increased global transparency, there is a negative perception of low-tax jurisdictions as popular places for foreign trusts to be established. On the other hand, the United States is generally not negatively perceived in this context and has a strong reputation with respect to its trust laws. More U.S. states are competing with each other to provide the most attractive trust laws and are generally comparable to, if not better than, certain offshore trust jurisdictions.

As mentioned above, non-U.S. persons are increasingly considering establishing trusts in the United States even where neither the settlor nor any of the beneficiaries are U.S. persons. The United States can provide a sense of security to citizens of countries going through economic and political turmoil. Furthermore, while the United States does not participate with the CRS, it is attractive for its sense of privacy to families who have legitimate security risks in their home country (but are otherwise tax compliant).

Reasons Against

While there may be an overwhelming number of reasons in favor of domesticating a foreign trust, there could also be reasons not to do so.

Majority of Non-U.S. Beneficiaries

A foreign non-grantor trust may have a mixture of U.S. beneficiaries and beneficiaries who are non-U.S. persons (''non-U.S. beneficiaries''). The advantages of domesticating a foreign trust may not necessarily apply to the non-U.S. beneficiaries. In fact, if a foreign trust were to domesticate, it could unnecessarily result in a tax burden on what the non-U.S. beneficiaries ultimately receive from the trust. If the non-U.S. beneficiary is not taxable on a foreign trust's income until an actual distribution is received, and his or her home country does not have a throwback tax set of rules or a type of controlled foreign corporation rules that apply to trusts, having a foreign trust be maintained in a low-tax jurisdiction can allow the trust to grow tax-deferred. If a foreign non-grantor trust becomes a domestic non-grantor trust, it becomes subject to U.S. federal income tax on its worldwide income, thus depleting the trust assets by the U.S. federal taxes paid. In such cases, it would be advisable to consider domesticating only a portion of the foreign trust as it relates to the U.S. beneficiaries so that overall fairness is maintained among the beneficiaries. In some cases, it may make sense from a tax planning point of view for the entire trust to remain a foreign trust.

Asset Protection

Many offshore trust jurisdictions have very favorable asset protection laws. Some U.S. states have comparable asset protection laws, but many foreign jurisdictions have additional procedural hurdles for creditors, potentially deterring them from making a claim.

Some of the offshore trust jurisdiction laws protect against forced heirship claims and/or marital claims, making it easier to legitimately disinherit family members. And a majority of the U.S. states provide some degree of protection to heirs and ex-spouses, making domestic trusts an easier target for such type of claims. These would be negative factors in domesticating a foreign trust.

PLANNING CONSIDERATIONS

Necessary to Maintain Foreign Trust Status?

As discussed above, reasons may exist for domesticating or not domesticating a trust. It is possible under U.S. federal tax law to domesticate a foreign trust but still have such trust be classified as a ''foreign trust'' for U.S. federal tax purposes. Typically, this is accomplished by having the trust satisfy the ''court test'' but fail the ''control test'' by giving a non-U.S. person control over at least one substantial decision of the trust. For example, a non-U.S. person can establish a revocable trust governed by Florida law with a Florida resident trustee. While the non-U.S. person is alive, the trust will be classified as a foreign grantor trust. This planning can be particularly useful when the future beneficiaries at the time of the settlor's death will be all U.S. beneficiaries, as it eliminates most of the additional steps discussed earlier to decant

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

or migrate the trust. If drafted properly, the trust will automatically convert to a domestic trust following the death of the grantor.

Decant vs. Migrate?

Mechanics

As discussed above, each method has its own separate mechanics for implementing. Thus, the decision to decant or migrate will largely be driven by the terms of the foreign trust itself or the foreign trust's governing law. The foreign trust instrument or the governing law of the foreign trust may provide certain limitations on one method over the other.

UNI Considerations

The means of domestication can have a different effect on the recognition of UNI in a foreign non-grantor trust. In a decanting, the assets of the foreign trust are appointed to a new domestic trust. There is some debate on whether a decanting of a foreign trust to a domestic trust is viewed as a continuation of the foreign trust under a change of form, or whether the transaction is considered an appointment of assets to a new trust.[44] Although it is not clear, it seems at least in the international context that the decanting of a foreign trust to a domestic trust would be considered a distribution so that the domestic trust would need to include the foreign trust's DNI in gross income under §662 and, in the case of a non-grantor trust, be subject to the throwback rules on the receipt of UNI at the time of decanting.[45]

A change of situs of the foreign trust to the United States offers more certainty that the restructuring will not produce an accelerated recognition of U.S. federal income tax on the UNI of the foreign trust like a decanting. Such an event should not be considered a distribution, and any UNI in the trust should not be subject to the throwback rules at the time of domestication because it is the same trust. However, the trust would continue to carry the UNI, and future distributions to a U.S. beneficiary would still be subject to the throwback rules at the time of distribution.[46] To illustrate, the IRS has ruled that the change of situs of a foreign trust that has accumulated income will not avoid the throwback tax and interest charges.[47] However, DNI that accumulates after the trust is domesticated would not be subject to any throwback rules.

Information Reporting

In a decanting, the domestic non-grantor trust would file a Form 3520 to report the distribution from the foreign non-grantor trust and include a Foreign Nongrantor Trust Beneficiary Statement listing the tax attributes that should be reported. It is not clear in a change of situs scenario whether the now domestic trust should file anything with the IRS to give notice of the change of situs since there is no technical distribution requiring the filing of a Form 3520.

In some cases, the U.S. trustee of the domestic trust will take over ownership of one or more foreign financial interests held by the foreign trust. The U.S. trustee will need to be prepared to file any applicable U.S. information returns disclosing such ownership of foreign financial assets (e.g., Form 8938, Form 5471, Form 8621, Fin Cen 114).

Pre-Implementation Issues

Once a decision is made to either decant or migrate the foreign trust, other pre-implementation issues also may need to be considered. In some cases, a U.S. settlor or U.S. beneficiary may not have filed any of the applicable information returns discussed above. A practitioner who is aware of non-tax compliance issues may need to first advise of such and have them corrected before proceeding with the domestication.

---

[44] *See* New York Bar Tax Section Comments to Notice 2011-101 (where the receiving trust has substantially similar terms it is reasonable to view the Receiving Trust as a continuation of the Distributing Trust); *see also* ACTEC Comments on Notice 2011-101 (Distributing Trust distributes all of its assets to a Receiving Trust, a better approach would be to treat the distribution as a mere recasting of the Distributing Trust and to treat the Receiving Trust as a continuation of the Distributing Trust); Florida Bar Tax Section Comments on Notice 2011-101 (same analysis as ACTEC).

See AICPA Comments on Notice 2011-101 (If, in the alternative, the decanting is viewed as a distribution to a receiving trust, the foreign trust will have a distribution deduction and the domestic trust will have gross income based upon the amount and character of the foreign trust's DNI. The domestic trust will also be subject to throwback tax and interest charge based upon any distribution of UNI of the foreign trust.)

[45] Reg. §1.665(b)-1A(b)(1) ("*One trust to another*. A distribution from one trust to another trust is generally an accumulation distribution"); *see also* Reg. §1.665(b)-1A(a)(2) ("An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year of the trust *by reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year. . . .")* (emphasis added). Further, the instructions to IRS Form 3520 make clear that a recipient, including a U.S. domestic nongrantor trust, of a distribution from a foreign trust does not have to be designated as a beneficiary under the terms of the foreign trust in order to report such distribution on a Form 3520. Moreover, by treating the decanting as a continuation of the foreign complex nongrantor trust would be contrary to the legislative decision to repeal the throwback rules as it relates to U.S. domestic nongrantor trusts as it would further the deferral of the UNI once appointed to the U.S. domestic nongrantor trust, which is the policy reason for why the throwback rules were enacted in the first place in order to discourage such deferral.

[46] *See* §665(c)(2)(A).

[47] Rev. Rul. 91-6.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

As discussed earlier, the existence of UNI in the foreign trust may lead to a decision in favor of migrating the trust as opposed to decanting the trust in an effort to not immediately trigger the application of the throwback tax rules. In cases where there is a large amount of UNI, other UNI reduction techniques may need to be considered along with domestication of the trust. For example, if the foreign trust has any non-U.S. beneficiaries, it may be possible to clean out such UNI by first distributing out to any one or more non-U.S. beneficiaries. Other strategies could be implemented as well.[48]

Often foreign trusts own an interest in one or more foreign companies. Such ownership may require an additional analysis under either the ''controlled foreign corporation'' tax regime or the ''passive foreign investment company'' tax regime. If either of such rules may be implicated, further consideration needs to be given as to whether such foreign companies need to be first restructured or consolidated prior to domestication of the foreign trust. A foreign trust also may be invested in one or more foreign mutual or hedge funds that may be considered PFICs the ownership of which by the new domestic trust could be terribly tax-inefficient. However, the sale of such PFICs may trigger unwanted PFIC tax consequences to the U.S. beneficiaries. This may call for other planning considerations, for example, a ''qualified electing fund'' election.[49]

Choice of U.S. Trustee?

In order to satisfy the control trust, a U.S. person needs to serve as trustee, or, if there is more than one trustee, then U.S. persons need to control all substantial decisions of the trust for it to qualify as a domestic trust. Another consideration for domesticating trusts is the selection of the U.S. trustee. Depending on the terms of the foreign trust, a U.S. beneficiary could become the trustee of his or her own trust. However, to prevent the trust's assets from being included in the U.S. beneficiary's gross estate, the domestic trust needs to prohibit the U.S. beneficiary from making distributions to himself unless they are for his health, education, maintenance, or support.[50] The U.S. beneficiary should also be precluded from using trust assets to discharge his personal legal obligations.[51]

Generally speaking, the U.S. trustee should have nexus with the U.S. state law that will govern the domestic trust so that there is no confusion on what law should apply to trust administrative matters. If there is no family member, friend, or trusted advisor resident of the U.S. state, this may require engaging a professional corporate trustee in that jurisdiction. If a good fit, a private trust company could be established in the jurisdiction where the domestic trust will be sitused while family members who are not resident of the jurisdiction serve as directors.

Choice of U.S. State Law?

Each U.S. state has its own body of trust law, perhaps making the decision on which jurisdiction to choose daunting. The narrowing down, though, will largely depend on the location of the trustee, beneficiary or assets, or relationships with potential service providers. For example, if the primary beneficiary is a Florida resident, the natural selection for the governing law would be Florida. But, other considerations (e.g., asset protection or relationship with a service provider) could make another jurisdiction more appropriate. A number of other reasons could be considered in choosing one U.S. state or another. The reasons and a discussion of the different U.S. states laws are beyond the scope of this article. However, the following chart lists some of the considerations and a comparison of some of the popular U.S. states used for establishment of domestic trusts.

---

[48] *See* Jennifer J. Wioncek and Hal J. Webb, *In Case You Thought This Was Easy, It Isn't: Exploring International Estate Tax and Income Tax Planning Strategies Involving Issues That Are Overlooked or Do Not Get The Attention They Deserve*, Florida Bar Tax Section 2017 International Tax Conference.

[49] §1295(b).

[50] *See* Reg. §20.2041-1(c).

[51] *Id.*

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

	TRUST LAW JURISDICTION				
	Delaware	Florida	South Dakota	Nevada	Wyoming
APTL[52]	Yes[53]	No	Yes[54]	Yes	Yes[55]
Perpetuity Period	Perpetual[56]	360 yrs.	Perpetual	365 yrs.	1,000 yrs.
Directed Trust	Yes	Yes[57]	Yes	Yes	Yes
Decanting Statute	Yes	Yes[58]	Yes	Yes	Yes
State Income Tax	Yes[59]	No	No	No	No

STATUTES

APTA: **DE:** 12 DE Code §§3570–76; **SD:**SD Codified L §§55-16-1–16; **NV:**NV Rev. Stat. §§166.010–170; **WY:**Wyo. Stat. §§4-10-502, 504, 506, 510–23

Perpetuity Rules: **DE:** 25 DE Code §503;**FL:**Fla. Stat. §689.225(2)(f);**SD:** SD Codified L §43-5-8;**NV:**NV Rev. Stat. §111.1031;**WY:**Wyo. Stat. §34-1-139

Directed Trust: **DE:** 12 DE Code §3313**; FL:**Fla. Stat. §736.0703; **SD:**SD Codified L §55-1-B-1-12; **NV:**NV Rev. Stat. §§163.553–56; **WY**: Wyo. Stat. §4-10-718

Trust Decant: **DE:**12 DE Code §3528; **FL:**Fla. Stat. §736.04117; **SD:**SD Codified L §§55-2-15–21; **NV**: NV Rev. Stat. §163.556; **WY**: Wyo. Stat. §4-10-816(a)(xxviii)

State Income Tax: **DE**: 30 DE Code §§1631–40

[52] Asset Protection Trust Law Legislation.
[53] Exception: Divorcing Spouse, Child Support, and Alimony.
[54] Exception: Divorcing Spouse, Child Support, and Alimony.
[55] Exception: Child Support.
[56] Caveat: Real property has a period of 110 years.
[57] Limitation: Only applies if the directing party is a co-trustee.
[58] Limitation: HEMS.
[59] Caveat: Only if the trust (i) was created by a DE resident, or (ii) has DE residents as beneficiaries.

Should You Build in Flexibility?

When planning for the creation or the domestication of a trust, it is important that flexibility be provided and future possibilities be considered. Thus, it is important for a practitioner to fully understand the facts and objectives as well as the personal circumstances of the settlor and potential beneficiaries. While there are many potential tax implications that could arise from a change in circumstances, some of them are triggered by the application of §684. Some examples are below.

Pursuant to §684, if a U.S. person contributes appreciated property to a foreign non-grantor trust, such transfer shall be treated as a sale or exchange where any such gain shall be immediately recognized by the U.S. person. In this same fashion, if a domestic non-grantor trust subsequently becomes a foreign non-grantor trust, the trust shall be treated as having transferred all of its assets to the foreign non-grantor trust and the trust is required to recognize gain on such deemed transfer.[60] The outbound migration of a domestic non-grantor trust can occur if a person who controls a substantial decision of the trust is no longer considered a U.S. person because such person has relinquished his or her U.S. passport or U.S. green card and would not qualify as a U.S federal income tax resident under the substantial presence test. If the conversion of the domestic trust to a foreign trust can be cured under certain procedures in the U.S. Treasury Regulations, the deemed sale event can be avoided.[61]

It may not always be possible, though, to cure such accidental outbound migration situations within the 12-month period prescribed in the Treasury Regulations. In that case, a decision needs to be made whether, upon domesticating the foreign trust, certain provisions should be included to require at all times that all substantial decision-making powers be held by a U.S. person and that such powers be automatically revoked if the individual becomes a non-U.S. person. In such event, the family may wish that the person continue to hold such power, and there may be no built-in gain in the trust assets to cause any concern under §684. Therefore, including a provision by which the powerholder's power automatically ceases may not be flexible enough. The practitioner may want to instead insert language requiring that a U.S. tax lawyer review the situation (at some future date) and assess the trust's options at such later time.

Laws are constantly changing, and a client may wish to no longer have a trust governed by the laws of a particular U.S. state and could consider again relocating the trust outside of the United States. For ex-

[60] Reg. §1.684-4(a).

[61] Reg. §1.684-4(c), §301-7701-7(d)(2)(i)-(ii).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

ample, if all the beneficiaries are no longer U.S. persons, the intended purposes of domesticating the trust in the first place may no longer be relevant. By changing the governing law and administration of the trust to a jurisdiction outside of the United States, it would likely result in the failure to satisfy the ''court test'' causing the domestic trust to become classified as a foreign trust and, thus, trigger the application of §684. However, it is possible that such tax result can be avoided by simply distributing all of the trust assets first out to the beneficiaries who can separately establish a new foreign trust outside of the United States with the advice of the home country's tax counsel. The intentions of the settlor and purpose of the trust must also be taken into account.

CONCLUSION

When advising a client on the domestication of a foreign trust, a plethora of issues need to be considered. As in any client situation, the practitioner needs to also be mindful of his or her ethical obligations. With the United States not being a party to CRS, there is debate whether it is ethical to assist a foreign client whose sole motivation for establishing a trust in the United States is to avoid CRS reporting. If the practitioner knows or suspects that the client's motivation is to avoid home country reporting and tax obligations, there could be professional misconduct issues relating to furthering an illegal or fraudulent action.[62] Under U.S. federal case law, the advisor may even face the risk of prosecution in the United States.[63]

[62] Fla. Prof'l Responsibility Conduct Rule 4-1.2(d).

[63] *See generally Pasquintino v. United States*, 544 U.S. 349 (2005).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

My Big Fat *Grecian* Divorce: A Labyrinthine Tale of ECI

By Alfred H. Bae, Esq.[*]

LEGISLATIVE INTERVENTION — §864(c)(8)

The rules for determining when income is effectively connected with the conduct of a U.S. trade or business (effectively connected income or ''ECI'') are often reminiscent of the great Labyrinth in Greek mythology.[1] As taxpayers and tax professionals, we find ourselves winding our way through Subchapter N's dizzying uncertainty, at times doubling back in desperate search for guideposts. New §864(c)(8) offers a welcome beacon in the convoluted ECI journey.[2]

Section 864(c)(8) applies an aggregate theory of partnership taxation to the sale or exchange of a partnership interest by a foreign partner in a partnership that is engaged in a U.S. trade or business. If such partnership is engaged in a U.S. trade or business and the disposition of its assets would give rise to ECI, then a portion of any gain or loss on the disposition of the partnership interest will itself be ECI. The portion of partnership gain or loss that is effectively connected is determined by calculating the ratio of the partner's distributive share income that would result in effectively connected gain or loss upon a sale of all of the assets of the partnership for fair market value, divided by that partner's total distributive share of gain or loss upon sale of all of the partnership assets.[3] This ratio is then applied against the actual gain or loss upon sale or exchange of the partnership interest.

Section 864(c)(8) defers to the Foreign Investment in Real Property Tax Act (FIRPTA)[4] regime and requires that any potential ECI under §864(c)(8) be reduced by any FIRPTA amount treated as ECI. Additionally, the new rules require that if there is ECI under §864(c)(8) the transferee must withhold under new §1446(f) in an amount equal to 10% of the amount realized on the disposition. If the transferee fails to withhold, the partnership is required to deduct and withhold the same amounts from any distributions to the transferee.[5]

The freshly minted provisions drop the guillotine blade on a quarter-century-old debate. It cannot be denied that this statutory override of non-statutory law now creates some measure of utilitarian predictability and efficiency for future taxpayers. The following vignette is the story of two authorities prior to the enactment of §864(c)(8). For a five-month span in 2017, *Grecian Magnesite*[6] enjoyed the upper hand over the 26-year-old Rev. Rul. 91-32 in the contest to establish whether gain upon disposition of a foreign partner's partnership interest in a partnership with a U.S. trade or business was ECI. In Rev. Rul. 91-32, the Internal Revenue Service ruled that the gain in the partnership interest at issue was taxable as ECI. But, in *Grecian Magnesite*, the Tax Court held that the gain on the disposition of a partnership interest by a foreign partner, by itself, was not ECI. Both authorities stood as examples not only for their ultimate conclusions, but also for the application of the ECI rules provided within their pages.

GENERAL PRINCIPLES

Entity vs. Aggregate

The fundamental tension in partnership tax is the aggregate-versus-entity theory of partnership. Put simply, should the partnership be considered a collection of its partners (aggregate) or respected as distinct from its partners? With regard to the basic rules of

---

[*] Alfred Bae is a Manager in the Transaction Tax group in Ernst & Young's Houston office. His practice consists of domestic and cross-border tax structuring and other tax planning with respect to a variety of business combinations and dispositions. He received both his J.D. and Tax LL.M. from the Northwestern University School of Law in Chicago, Ill. The views expressed in this article are solely of the author and do not necessarily represent the view of Ernst & Young, LLP.

[1] The author acknowledges Alan B. Stevenson's 1983 article in the Northwestern Journal of International Law and Business titled *Is the Connection Effective? Through the Maze of Section 864* for the maze motif that this author thought so appropriate to the ECI rules as to borrow it.

[2] Section 864(c)(8), added by Pub. L. No. 115-97 (hereinafter the 2017 tax act), §13501(a)(1), applies to sales, exchanges, or other dispositions occurring on or after November 27, 2017. All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

[3] §864(c)(8)(B).

[4] The FIRPTA rules, found in §897, generally require a foreign person who disposes of an interest in U.S. real property to recognize any gain on such disposition as ECI. The rules apply to dispositions of partnership interests in partnerships with U.S. real property as well.

[5] §1446(f)(4), as added by the 2017 tax act, §13501(b). Currently, as stated in Notice 2018-8, the withholding requirement is not in effect for publicly traded partnerships. *See also* Notice 2018-29 discussed below. *See also New York State Bar Association Report No. 1387*, requesting guidance under §864(c)(8) and §1446(f). The report identifies a number of potential issues with the application of §864(c)(8), including its application to nonrecognition transactions and coordination with treaty rules.

[6] *Grecian Magnesite Mining Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

taxability under §701, and character under §702(b), a partnership is treated as an aggregate. The partners themselves, rather than the partnership, are responsible for paying tax on the income of a partnership in their individual capacities.[7] As for the character of income, gain, loss, deduction, or credit included in the partner's distributive share, character should be determined as if the partner realized those items directly from the source.[8]

On the other hand, the entity theory of partnership tax treats the partnership as if it had a separate tax existence. Evidence for this theory is found in §741, which provides, in part, that upon sale or exchange of a partnership interest, gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset.[9] Additional support for the entity theory of partnerships can be found in §736(b)(1), which provides that payments in liquidation of a partnership interest are considered distributions by the partnership, and §731(a), which provides that any gain or loss recognized on distribution is treated as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

Any discussion of the disposition of a partnership interest would not be complete without a mention of §751. In its most basic form, the rule under §751 treats the amount received in a sale or exchange of a partnership interest, or distribution from the partnership that is treated as a sale or exchange of a partnership interest, as partially received in exchange for ordinary income partnership assets — unrealized receivables and inventory.[10] This is an example of an exception to the general rule of entity theory upon a sale or exchange of a partnership interest or a distribution treated as such.

Enter the Labyrinth — Taxation of Nonresident Aliens and Foreign Corporations

The two primary categories of taxable income for nonresident aliens and foreign corporations under U.S. statutory tax law are:

- Category 1 — income not connected with a U.S. business.[11]
- Category 2 — income connected with a U.S. business.[12]

Category 1 consists of several subcategories, the most common of which may be fixed or determinable annual or periodical (FDAP) gains, profits, and income, which includes dividends, interest, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and similar items. It is important to note that these types of income and gain are only subject to the Category 1 regime under §871(a) and §881 if the amounts received are not also effectively connected with the conduct of a trade or business within the United States.[13] This language implies that there may be overlap between Category 1 and Category 2 and also pronounces the priority of Category 2 over Category 1. The remainder of this article will not discuss Category 1 income.

Category 2 consists of income from a U.S. business that is effectively connected with the conduct of a trade or business within the United States, otherwise known as ECI. It can be very challenging to determine whether a nonresident alien or foreign corporation has ECI as the rules are neither clearly stated nor well organized within the Code and regulations. A simplified ECI rubric may assist in the ECI analysis — a trail of breadcrumbs as we enter the convolutions of the Labyrinth.

Steps in the ECI Analysis

There are three main steps in the basic ECI analysis:

(1) Determine whether the nonresident alien or foreign corporation has a U.S. trade or business;

(2) Determine whether the income in question is U.S.-source income;[14] and

(3) Determine whether the income is ECI.

An ECI analysis requires one to consider each step in the order presented. For example, if a nonresident

[7] §701.

[8] §702(b).

[9] The government in *Grecian Magnesite* asked whether the "capital asset" referred to in §741 may not be the partnership interest itself, but the underlying assets of the partnership that are treated as capital assets when the partnership interest is sold. In the Tax Court's opinion, and the view of the author, this argument grasps at straws — the capital asset referred to in §741 is most definitely, the partnership interest.

[10] In the case of §751(b), inventory must be substantially appreciated.

[11] §871(a), §881.

[12] §871(b), §882.

[13] §871(a)(1), §881(a) (flush language).

[14] It is possible for gain from the sale or exchange of personal property that is not U.S. source to be taxable as ECI under §864(c)(4)(B)(iii); however, this provision does not apply when the property is sold or exchanged for use, consumption, or disposition outside of the United States and an office or other fixed placed of business in a foreign country materially participated in the sale.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

alien or foreign corporation has a U.S. trade or business, but the income in question is not U.S.-source income, then the analysis ends — the income is not ECI.[15] The explanation of the steps below is tailored to the concepts necessary to analyze Rev. Rul. 91-32 and *Grecian Magnesite*; therefore, it does not explore the full import of the concepts associated with each step. Furthermore, it is indispensable to an understanding of ECI, as evidenced by §864(c)(8), that there are specific provisions that may override the basic three-step rubric. The FIRPTA rules are one such example.

The question of whether a nonresident alien or foreign corporation has a trade or business within the United States is simple if the nonresident alien or foreign corporation is a foreign partner in a partnership that itself has a U.S. trade or business. Under §875(1), the partnership's U.S. trade or business will be attributed to the foreign partners. That completes the U.S. trade or business analysis necessary for both Rev. Rul. 91-32 and *Grecian Magnesite*.

Next, to determine whether the income or gain is U.S.-source income, consult §861–§863 and §865. Both Rev. Rul. 91-32 and *Grecian Magnesite* apply §865 to determine source of the gain. Section 865(a) provides source rules for personal property sales. The general rule is that a sale by a U.S. resident shall be sourced in the United States and a sale by a nonresident is sourced outside the United States.[16] As a result, the sale of personal property by a foreign partner in a partnership is sourced outside of the United States. As tidy as this is, this is not the end of the inquiry. Under §865(e)(2)(A), if a nonresident maintains an office or other fixed place of business in the United States, then sale from personal property attributable to such office or other fixed place of business shall be sourced in the United States (U.S. Office Rule). The U.S. Office Rule is the basis for finding U.S.-source income in Rev. Rul. 91-32, and also constitutes the dispositive ECI analysis in *Grecian Magnesite*.

The U.S. Office Rule refers to "the principles of section 864(c)(5)"[17] to determine whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business.[18] Under §864(c)(5), there is a two-part test to determine whether income, gain, or loss is attributable to an office or other fixed place of business, and both parts of the test must be satisfied. The first part of the test asks whether the office or fixed place of business is a material factor in the production of the income, gain, or loss. The second part of the test asks whether the office or fixed place of business regularly carries on activities of the type from which such income, gain, or loss is derived.[19]

The final step in our rubric is to determine the type of income and to apply the relevant ECI rule. Within §864(c)'s definition of ECI, there are two types of ECI: (1) FDAP-type income and capital gain from sources within the United States;[20] and (2) everything else.[21] With respect to the first kind of ECI, this is a part of the Labyrinth that looks like somewhere we have been before, but is not. This is not FDAP income itself (i.e., Category 1). This is ECI that consists of the type of income that could be FDAP if it were not effectively connected with a U.S. trade or business, as you will recall the flush language in §871(a)(1) and §881(a). This is confusing and the Tax Court itself misunderstood this concept in its initial final draft of the *Grecian Magnesite* opinion from July 13, 2017, which it corrected by order three days later.[22]

FDAP-Type Income and Capital Gain From Sources Within the United States: Continuing with our final step in the ECI rubric, with respect to the first kind of ECI under §864(c)(2), if the potential ECI is FDAP-type income and capital gain, a two-part test applies that requires only one of the two alternatives to be true. The first alternative, also called the "asset use test," asks whether assets used in a U.S. trade or business gave rise to the potential ECI.[23] The second alternative, also called the "business activities test," asks whether the business activities of the U.S. trade or business were a material factor in the realization of the potential ECI.[24] To reiterate, if the potential ECI is FDAP-type income or capital gain, apply either the asset use test or business activities test to satisfy the final step of our rubric. Now, to turn to the second type of ECI — everything else.

Everything Else: The second type of ECI described in §864(c)(3) is income that is from U.S. sources, but is not the FDAP-type income or capital gain described in §864(c)(2). The ECI analysis under this income type is simple. If a nonresident alien or foreign corporation has a trade or business within the United States and the income at issue is U.S.-source income, then that U.S.-source income is ECI if it is not FDAP-type income or capital gain. The rule provided in §864(c)(3) is also referred to as the "Limited

[15] This assumes that §864(c)(4) does not apply.

[16] §865(a)(1)–§865(a)(2).

[17] Section 864(c)(5) relates to certain foreign-source income of a nonresident alien or foreign corporation that can be treated as ECI.

[18] *See* §865(e)(3).

[19] §865(c)(5)(B).

[20] §864(c)(2).

[21] §865(c)(3).

[22] *Grecian Magnesite Mining*, Tax Court Order, No. 19215-12 (July 18, 2017).

[23] Reg. §1.864-4(c).

[24] *Id.*

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Force of Attraction Rule'' due to its tractor-beam-like ability to pull income into the U.S. tax net with little regard to whether such income is connected with the conduct of U.S. business.

REV. RUL. 91-32

In Situation 1 of Rev. Rul. 91-32 (the ''Ruling''), a foreign partner in a partnership with a U.S. trade or business sold its partnership interest. The partnership owned property that it used in its trade or business. The Ruling stated that to the extent of the gain in the underlying property that was property used in a U.S. trade or business, the foreign partner would have a pro rata ECI portion of its actual gain from the sale of the partnership interest.

Diagram 1 — Rev. Rul. 91-32 — Situation 1

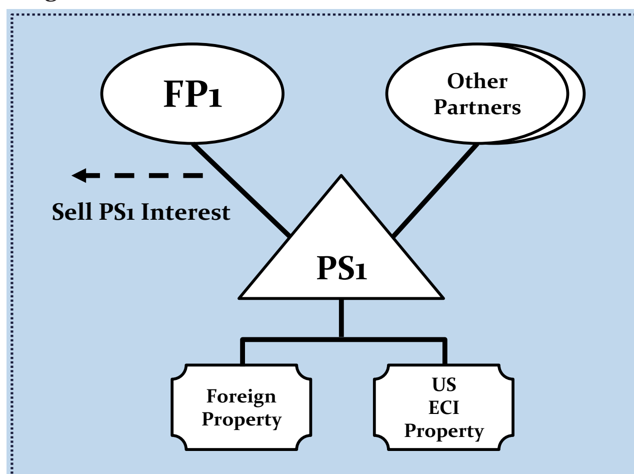


Diagram 2 — Rev. Rul. 91-32 — Situation 2: Assets of the Partnership

	FMV*	Basis*
Cash	300	300
Non US Real property	1000	500
Non US Machinery	100	500
Property used in US trade or business	500	200

**In thousands*

Situation 2 of the Ruling provided an illustrative calculation of the ECI portion of the gain from the disposition of the foreign partner's interest. In order to determine the ECI portion of the total gain of $100,000, the Ruling hypothesized a sale of all of the partnership assets. The total gain recognized from the sale of all of the assets would have been $400,000. The hypothetical gain from the single asset that the partnership had owned that was used in a U.S. trade or business was $300,000. Therefore, 75% ($300,000/ $400,000) of the gain from a hypothetical asset sale would have been ECI. This ratio was applied to the total gain on the disposition of the foreign partner's interest and so $75,000 of the total $100,000 gain on the sale of the partnership interest was ECI.

The Government's ECI Analysis

The IRS's reasoning, applicable to two of the three situations in the ruling, found that the foreign partner had a U.S. trade or business based on the fact that the partnership had a U.S. trade or business — recall §875(1).[25] Next, the IRS's U.S.-source analysis employed the U.S. Office Rule under §865(e)(2). The lack of adequate treatment of the U.S. Office Rule is Rev. Rul. 91-32's greatest shortcoming. To arrive at its conclusion that the gain was attributable to a U.S. office and thus U.S.-source gain, the Ruling merely stated that §875(1) attributed both the U.S. trade or business of the partnership and the U.S. office to the disposing foreign partner and, then, in almost a non sequitur — ''[i]ncome from the disposition of a partnership interest by the foreign partner will be attributable to the foreign partner's fixed place of business in the United States. See section 865(e)(3).''

Despite this fatal flaw, there is value in the remainder of Rev. Rul. 91-32's explanation of the ECI analysis. So far, the IRS had found a U.S. trade or business and U.S.-source income. It next pointed to §864(c)(2) as the relevant ECI provision as the gain in question was capital gain. Because §864(c)(2)'s provisions governed, the IRS applied the asset use/business activities test. It conceded that the gain from the disposition of the interest in the partnership was not directly realized due to the business activities of the U.S. trade or business. However, because the §864(c)(2) analysis is an either/or test, the asset use test itself was sufficient to find ECI. The Ruling found that the gain was derived from assets used or held for use in the disposing foreign partner's U.S. trade or business. The IRS's assertion that the asset use test was satisfied rested on the following: ''*the value of the trade or business activity of the partnership affects the value of the foreign partner's interest in the partnership*.'' Although the ECI question was answered in the affirmative, the application of the asset use test lacked precision.

[25] Situation 3 of Rev. Rul. 91-32 performs an analysis under analogous treaty principles.

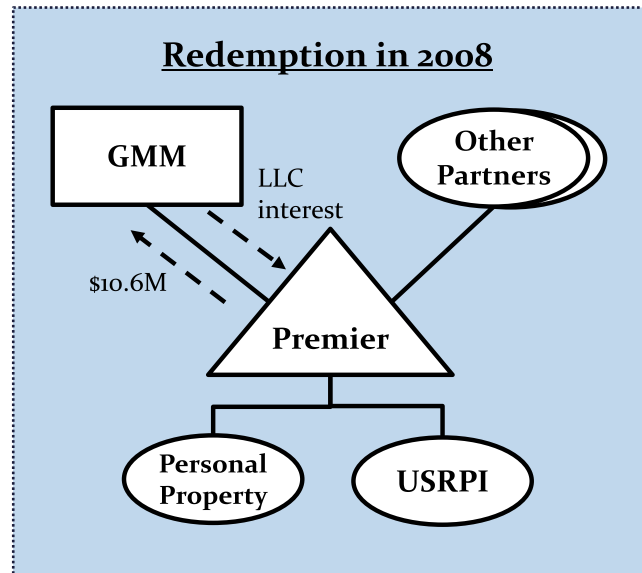
© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Rev. Rul. 91-32 was highly criticized as lacking statutory authority.[26] Some argued that although the policy was not incorrect, legislation did not exist to justify the result of the ruling. The most vociferous criticism attacked the application of the U.S. Office Rule to the sourcing analysis.[27] The potential to hang the result of Rev. Rul. 91-32 on the partnership anti-abuse rules was discussed.[28] Furthermore, there had been attempts by the Obama Administration to codify Rev. Rul. 91-32, which some commentators observed was the government's tacit acknowledgement that the ruling itself rested on brittle reasoning that might not hold up to challenge in the absence of a new statute.[29]

THE *GRECIAN* WEDDING

The facts of *Grecian Magnesite* were substantially similar to the facts of Rev. Rul. 91-32. Premier Chemicals LLC (Premier) was a U.S. limited liability company with a U.S. office and a U.S. trade or business. Premier's foreign partner, Grecian Magnesite Mining (GMM), was a corporation organized in Greece that did not have a U.S. physical presence or connection to the United States other than the ownership of a partnership interest. Premier and GMM were each engaged in mining activities as its primary business. In a set of two redemption transactions, Premier distributed money to GMM, the effect of which was an exchange of GMM's entire partnership interest. Although this was not a sale as under Rev. Rul. 91-32, the Tax Court indicated that the fact pattern was not materially different. Accordingly, the court's opinion was partially framed as a criticism of the Ruling.

Diagram 3 — Grecian Magnesite — The Redemptions



The case began with a summary of the relevant partnership tax statutes — §736(b)(1), §731(a), and §741 — culminating in the sub-conclusion that, unless otherwise prescribed by statute, a redemption of a partnership interest was to be treated, under entity theory, as an actual distribution with respect to the partnership interest and not as if the gain was derived from a hypothetical sale of the underlying assets as in Rev. Rul. 91-32. The Tax Court noted both §897(g) and §751 as statutory exceptions to the default rule of entity theory.

As for Subchapter N and the ECI analysis, the Tax Court, like the IRS in Rev. Rul. 91-32, found that a foreign partner had a U.S. trade or business due to the U.S. trade or business of the partnership under §875(1). The next step, the source of income analysis, was the dispositive portion of the opinion.

The U.S. Office Rule

As in Rev. Rul. 91-32, §865 was the relevant source rule regardless of whether it was the partnership interest that was disposed of or the partnership assets other than any U.S. real property interests under the §897 FIRPTA rules.[30] The general rule under §865 provides that dispositions of personal property by a nonresident (such as a foreign corporation) are sourced outside the

[26] *See, e.g.,* Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners*, 76 Tax Notes 1331 (Sept. 8, 1997).

[27] *See* Bell and Shoemaker, *Revenue Ruling 91-32: Right Result for the Wrong Reasons*, 9 J. Partnership Tax'n 80 (1992).

[28] The partnership anti-abuse rule in Reg. §1.701-2(e) allows the government to treat a partnership as an aggregate (in whole or in part) of its partners unless a provision in the Code or regulations prescribes the treatment of a partnership as an entity and the ultimate tax results of such treatment are clearly contemplated by that provision.

[29] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (Feb. 2012).

[30] Premier LLC did own a U.S. real property interest, which it conceded was subject to taxation as ECI under §897(g).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

United States; however, recall the exception under the U.S. Office Rule of §865(e)(2), which treats such income that is attributable to an office or other fixed place of business in the United States as U.S.-source income. The Tax Court stated that it purposefully assumed attribution of Premier's U.S. office to GMM without an application of law because it anticipated that the gain would not be attributable to any assumed office.[31]

With respect to the ''material factor'' prong of the U.S. Office Rule, the IRS first argued that Premier's U.S. office, which was assumed attributed to GMM, would have been a material factor in a hypothetical sale of the assets owned by Premier. Consistent with its rejection of aggregate partnership theory in the sale of GMM's partnership interest, the Tax Court immediately dismissed this argument as inapplicable. The IRS made a familiar alternative argument similar to its reasoning in Rev. Rul. 91-32 applying the ''asset use test'' for ECI under Reg. §1.864-4(c)(2). The IRS argued that the activities of the U.S. office of Premier increased the value of the underlying assets of Premier and, thus, the overall value of the Premier business as a going concern. Due to this increase in the value of the Premier business, the value of GMM's partnership interest increased. The Tax Court drew a distinction between the activities of the underlying business and the gain due to the disposition of a partnership interest. In doing so, the court agreed with GMM that under Reg. §1.864-6(b)(2)(i), which the court conceded was admittedly ''not directly on point'' yet still presented useful guidance, a U.S. office should not be considered a ''material factor'' merely because it created underlying value or performed clerical functions incidental to the production of the gain. To have been a ''material factor,'' the U.S. office must have somehow been a ''material factor'' in the actual redemption transaction.

The Tax Court found that Premier's U.S. office did not satisfy the ''material factor'' prong of the ''attributable to'' test. This in itself was enough to conclude that the gain upon disposition of the partnership interest was not U.S.-source gain because the U.S. Office Rule's test is a conjunctive ''and'' test. However, the court finished out its U.S. Office Rule discussion by turning to the second prong under §864(c)(5)(B) — whether the U.S. office regularly carried on activities of the type from which the gain on the redemption of the partnership interest was derived. Put differently, did the gain on the interest arise from ordinary course activities of the U.S. office?

The government continued to pump a dry well in making its value argument. According to the IRS, the ordinary course activities of Premier gave rise to the gain upon disposition of the partnership interest. The Tax Court again made the distinction between the actual redemption transaction and the value created by the underlying business. The court explained that in order for the ordinary course activities of the U.S. office to generate the partnership redemption gain, Premier would have to be in the very business of buying and selling its own partnership interests. Because Premier only redeemed the interests of two distinct partners over the course of seven years, it was not possible to say that redeeming its own partnership interests was an ordinary course activity. Consequently, Premier's activities failed both prongs of the ''attributable to'' U.S. office test as applied to GMM's redemption gain. Recalling that the U.S. Office Rule relates to whether the redemption gain is U.S. source, if the gain was not U.S. source, then, in this circumstance, the court could conclude that the redemption gain was not ECI without undergoing a separate ECI analysis under either §864(c)(2) or §864(c)(3).

Irreconcilable Differences

Grecian Magnesite is far from a flawless application of the ECI rules prior to the enactment of §864(c)(8). Despite its shortcomings, the case stands as rare authority both in its attempt to apply complex aggregate-versus-entity principles across borders and in its genuine effort to make sense of U.S. sourcing rules relevant to determining ECI. Furthermore, perhaps in illustrating the uncertainty in the application of the ECI rules, *Grecian Magnesite* may serve as a valid criticism of the current taxing regime.

Diagram 4 – Comparison Summary

Issue	Rev. Rul. 91-32	*Grecian Magnesite*	§ 864(c)(8)
US Trade or Business	§ 875(1) – USTB of partnership is USTB of foreign partner	§ 875(1) – USTB of partnership is USTB of foreign partner	***Requirement***: Partnership itself must have a USTB
US Source	§ 865(e)(2) – US office – no analysis, merely concludes US Source with cite to § 865(e)(3)	§ 865(e)(2) – US office - depends on material factor and ordinary course tests	***Requirement***: Disposition of assets must be US Source to partnership
Effectively Connected Income?	§ 864(c)(2) – requires asset use and business activities test	§ 864(c)(3) – if USTB and US source, then ECI	***Result***: If disposition of assets would be ECI to partnership, then pro rata ECI on partnership interest gain

SHOWDOWN WITH THE MINOTAUR

In Greek mythology, solving the puzzle of the Labyrinth came with a great reward. At the center of

[31] The Tax Court stated in footnote 19, ''The parties dispute whether such attribution of Premier's office to [Grecian Magnesite] is appropriate here. We assume, without holding, that [Grecian Magnesite] did have an office or other fixed place of business within the United States — i.e., Premier's. Because we hold that in any event the disputed gain was not ''attributable to'' any such office, we need not resolve this dispute.''

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

the Labyrinth, there was one final challenge — Asterion, the Minotaur. The enactment of §864(c)(8) ends a specific debate regarding the disposition of a foreign partner's interest in a partnership with a U.S. trade or business. Its function is to statutorily override *Grecian Magnesite*. However, §864(c)(8) does not address broader ECI and sourcing issues touched upon in Rev. Rul. 91-32 and *Grecian Magnesite*. Therefore the journey within the maze of the ECI rules will persist. Although we have not yet gazed upon Asterion's frightening face, the awful sound of his grunting breaths and the stomping of his hooves grow more pronounced, but we, as bold tax warriors, charge forth to challenge him in hopes of unlocking Subchapter N's greatest truths.

CODA: §1446(f)

Although a detailed discussion of the withholding regime under §1446(f) is beyond the scope of this article, due to the recent release of Notice 2018-29 (the ''Notice''), which announces that the Department of Treasury and the IRS intend to issue regulations under new §1446(f), a brief overview of the Notice is appropriate. As explained above, §1446(f)(1) requires the transferee of a partnership interest, the disposition of which is subject to §864(c)(8) gain recognition, to deduct and withhold tax equal to the amount realized on the disposition.[32] If the transferee fails to withhold, then under §1446(f)(4) the partnership must deduct and withhold from distributions to the transferee an amount equal to the amount that the transferee should have withheld, plus interest.[33]

There is a significant exception to the withholding requirement when the transferor supplies the transferee with an affidavit stating, under penalty of perjury, that the transferor is not a foreign person[34] — in which case §864(c)(8) should not apply at all. Other than these wispy skeletal concepts, §1446(f) lacks for the essential muscle and sinew that is required even for the most basic taxpayer compliance, thus, Notice 2018-29 meets the immediate need for guidance by providing both temporary rules and describes the issues the government intends to address in the near term in the interest of ''effective and orderly implementation'' of §1446(f). Fortunately, a ready-made analog exists in §1445 for FIRPTA withholding. Until regulations are issued under §1446(f), the Notice generally adopts the forms and procedures under §1445 and the regulations thereunder. Similarly, when furnishing an affidavit of non-foreign status, taxpayers may rely on the regulations under the FIRPTA non-foreign affidavit rules found in §1445(b)(2).[35]

Similar to circumstances when a transferor is not a foreign person, it seems appropriate that in situations where no gain results from a transfer, no withholding should result under §1446(f) notwithstanding that there was an amount realized. Section 6.02 of the Notice provides that the government intends to issue regulations that allow a transferee an exception from withholding if the transferor issues a certification, signed under penalty of perjury, that the transfer of its partnership interest will not result in realized gain. Section 6.02 draws a distinction between gain not realized at all and gain realized, but not recognized, such as in a nonrecognition transaction. For nonrecognition transactions, §6.05 of the Notice describes forthcoming regulations that address nonrecognition transactions that again key off of FIRPTA withholding concepts, this time found in Reg. §1.1445-2(d)(2). Until guidance is issued, the Notice allows an exception to §1446(f) for nonrecognition transfers. The exception includes distributions from partnerships to partners in which the partner is the transferee of a partnership interest — i.e., such as a ''redemption'' distribution.

The Notice provides descriptions for two threshold exceptions that eliminate the §1446(f) withholding requirement when a certification is received by a transferee that states either (1) the transferor partner who was a partner for the entirety of the prior three tax years had an allocation of effectively connected taxable income, within the meaning of Reg. §1.1446-3, that was less than 25% of its total distributive share of partnership income from the year; or (2) the partnership's gain that would be ECI if the partnership sold all of its assets at fair market value would be less than 25% of the total gain on the hypothetical sale. Note that included in ECI gain for the partnership percentage calculation is FIRPTA gain under §897.

The additional forthcoming regulations announced in the Notice include rules related to the following.

- The transferee's ability to rely on certifications from either the transferor or the partnership itself regarding the amount of the transferor's share of liabilities in the partnership in determining amount realized on a partnership interest transfer.
- Limitation of the amount of withholding required by §1446(f)(1) to the amount realized, less the decrease in the transferor's partner's share of partnership liabilities (or the entire amount realized when partner's share of liabilities cannot be established) when the amount otherwise required to be withheld under §1446(f) exceeds such amount.

[32] §1446(f)(1).

[33] §1446(f)(4).

[34] §1446(f)(2).

[35] *See* Reg. §1.1445-2(b).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- The partnership's ability to rely on partnership books and records to establish the tax basis of a transferor partner's partnership interest when the partnership makes a distribution to the partner (i.e., the partnership is the transferee of the partnership interest).

- Payments subject to both §1445(e)(5) or Reg. §1.1445-11T(d)(1) and §1446(f)(1) are only subject to §1445 payment and reporting requirements, unless the transferor has obtained a withholding certificate as provided for in Reg. §1.1445-11T(d)(1), in which case the transferee must withhold the larger amount of either the §1445(e)(5) withholding amount or §1446(f)(1). In this case, a transferee that has met the requirements for either §1445(e)(5) withholding or §1446(f)(1) withholding will be deemed to have satisfied the other.
- For tiered partnerships, look-through concepts are employed such that if a transferor disposes of an interest in an upper-tier partnership that owns an interest in a lower-tier partnership that owns property that would give rise to ECI if that lower-tier partnership disposed of such property, then §864(c)(8) and §1446(f) should apply to the disposition of the upper-tier partnership interest.

Finally, Notice 2018-29 specifies that regulations will be issued that provide that the withholding requirement under §1446(f)(4) for a partnership to withhold when the transferee fails to withhold under §1446(f)(1), will not be effective until regulations or guidance have been issued under that section.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Canadian Tax Perspective

Elimination of 30-Day Requirement and Impact on Cross-Border Estate Planning for Canadian Families

By Gregg M. Benson, Rhonda Rudick, and Peter A. Glicklich[*]

As part of the Tax Cuts and Jobs Act (the ''Act''),[1] signed into law on Dec. 22, 2017, Congress and the President made historic changes to the U.S. system of international taxation. Although many of these changes targeted the income tax consequences of cross-border investments, they are expected to have a significant impact on the private client industry and international estate planning, specifically for non-U.S.-based families holding U.S.-situs assets with one or more family members who are resident in, or citizens of, the United States. The main goals of such a family upon the death of a Canadian family member are to (i) protect against U.S. estate tax on the U.S.-situs assets held by the decedent, (ii) provide for a U.S. tax basis step-up of the U.S.-situs assets, and (iii) avoid or minimize any U.S. income tax exposure.

BACKGROUND

By way of background, the United States imposes an estate tax on (i) the worldwide assets of citizens and residents of the United States and (ii) the U.S.-situs assets, including U.S. stocks and securities, of nonresident aliens (i.e., people who are neither residents nor citizens of the United States). The Act increases the U.S. estate tax exemption for U.S. citizens and residents to $11.2 million (adjusted annually for inflation) for periods beginning in 2018 and ending prior to 2026, following which the U.S. estate tax exemption reverts to pre-Act levels.[2] For nonresident aliens holding U.S.-situs assets, however, in the absence of benefits under an applicable treaty, only $60,000 of U.S.-situs assets can be exempt from U.S. estate tax. The U.S.-Canada Tax Treaty (the ''Treaty'') provides some relief from the U.S. estate tax rules for Canadian residents holding U.S.-situs assets in excess of the $60,000 exemption.[3] Under the Treaty, a Canadian resident can claim an exemption from U.S. estate tax based on a pro rata portion of the full exemption available to U.S. citizens and residents based on such person's ratio of U.S.-situs assets to worldwide assets.

A common estate planning strategy for Canadian residents owning U.S.-situs assets in excess of the U.S. estate tax exemption amount is to hold such U.S.-situs assets through a Canadian corporation — as stock of a Canadian corporation held by a Canadian resident is not a U.S.-situs asset, even if the corporation owns U.S.-situs assets. If, however, upon the death of the Canadian resident, the stock of the Canadian corporation is inherited by a U.S. citizen spouse or one or more children who are U.S. persons, the Canadian corporation could be treated as controlled foreign corporation (CFC) for U.S. federal income tax purposes.

Moreover, a particular provision of the Act is already having a major impact on international estate planning for cross-border families due to a modification to the CFC regime. The CFC regime requires ''United States shareholders'' (''U.S. Shareholders,'' as defined below) of a CFC to currently include in income certain types of passive income (referred to as ''Subpart F income'') earned by the CFC regardless of whether such income is actually distributed to such U.S. Shareholders.[4] A CFC is defined as a non-U.S. corporation in which U.S. Shareholders in the aggregate hold stock representing greater than 50% of the voting power or 50% of the value of such non-U.S. corporation.[5]

As mentioned above, the Act made certain significant revisions to the CFC regime. First, prior to the Act, a ''U.S. Shareholder'' was defined as a U.S. person that holds stock representing 10% or more of the voting power of a non-U.S. corporation. The Act expanded the definition of ''U.S. Shareholder'' to include any U.S. person that holds stock representing 10% or more of the value of the corporation.[6]

In addition, prior to the Act, the rules that attribute stock of a non-U.S. corporation to a U.S. person for purposes of determining whether such U.S. person is a U.S. Shareholder and whether such non-U.S. corporation is a CFC, prohibited the attribution of stock from a non-U.S. person to a U.S. person. The Act modified the applicable attribution rules requiring the downward attribution of stock owned (directly, indirectly or constructively) by a non-U.S. person to (i) any U.S. partnership in which the non-U.S. person

---

[*] Gregg M. Benson is a partner and Peter A. Glicklich is managing partner with the New York office of Davies, Ward, Philips & Vineberg LLP; Rhonda Rudick is a partner with the Montreal office of the firm.

[1] Pub. L. No. 115-97.

[2] §2010(c)(3)(C). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the ''Code'') or the Treasury regulations promulgated thereunder.

[3] §2012(b)(1).

[4] §951.

[5] §957(a).

[6] §951(b).

Tax Management International Journal
© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

holds an interest, and (ii) any U.S. corporation in which the non-U.S. person's ownership interest is at least 50%.[7]

Further, prior to the Act, a U.S. Shareholder of a CFC was required to include its share of Subpart F income of the CFC in income only if the non-U.S. corporation qualified as a CFC for at least 30 consecutive days during the year (the ''30-day requirement''). The Act eliminated the 30-day requirement, and, as a result, a U.S. Shareholder of a non-U.S. corporation that qualifies as a CFC for only one day during the taxable year may be required to include in income its pro rata share of the Subpart F income of the CFC.[8]

ESTATE PLANNING PRIOR TO THE REPEAL OF THE 30-DAY REQUIREMENT

Prior to the repeal of the 30-day requirement, a Canadian person that held U.S.-situs assets could protect against U.S. estate tax and permit U.S. heirs to inherit the U.S.-situs assets in a tax-efficient manner by implementing a planning technique combining both the 30-day requirement and the ''check-the-box'' regulations. Under these regulations, a taxpayer can elect to treat certain eligible entities that would otherwise be treated as corporations as pass-through entities for U.S. federal income tax purposes, with an effective date up to 75 days prior to the date in which such election was filed.[9] In addition to providing U.S. estate tax protection, this technique would result in a U.S. tax basis step-up in the U.S.-situs assets without triggering significant Subpart F income or U.S. federal income tax exposure.

Specifically, this strategy was available for a Canadian resident investing in U.S. stock or securities through a Canadian corporation, the shares of which are held by a Canadian trust that would be treated as a grantor trust for U.S. federal income tax purposes, for which the Canadian resident would be the settlor and U.S. heirs of the Canadian settlor would be the beneficiaries. As this strategy required certain entity classification elections to be made under the check-the-box rules, and Canadian corporations are ineligible to make such entity classification elections, the Canadian corporation first needed to be converted to an unlimited liability company typically organized under the laws of Nova Scotia, British Columbia or Alberta (''ULC''). An initial election would be made under the check-the-box rules for the ULC to be treated as a corporation for U.S. federal income tax purposes.[10] As a result of the grantor trust status of the trust, the Canadian resident would be treated, for U.S. tax purposes, as owning all of the assets of the trust, specifically the interests of the ULC and, during the life of the Canadian resident, no portion of the ULC would be treated as owned by the U.S. heirs, and there would therefore be no risk of CFC treatment during the Canadian resident's life.[11]

On the death of the Canadian resident, because the decedent died holding interests of a ULC that is treated as a corporation for U.S. tax purposes, and the interests of an entity treated as a Canadian corporation are not U.S.-situs assets, U.S. estate tax would not apply. In the absence of any elections, the CFC attribution rules would cause the ULC to be owned by the U.S. heirs, and, if there are sufficient U.S. heirs owning at least 10% of the ULC, the ULC would be treated as a CFC for U.S. tax purposes. If, however, a check-the-box election is made to treat the ULC as a pass-through entity for U.S. federal income tax purposes with an effective date less than 30 days after the decedent's death, the deemed liquidation from the check-the-box election would result in a stepped-up basis in the U.S. stock or securities held by the ULC without requiring the U.S. heirs to include any Subpart F income because the ULC would have qualified as a CFC for less than 30 days in the taxable year. As mentioned above, the check-the-box election can be filed with an effective date up to 75 days prior to the date on which the election is filed.[12] This strategy was relatively commonplace in cross-border estate planning, both in situations involving a grantor trust and in situations where the shares of the Canadian corporation were bequeathed to the U.S. Shareholder by the Canadian resident — until the Act repealed the 30-day requirement.

ESTATE PLANNING AFTER THE REPEAL OF THE 30-DAY REQUIREMENT

After the repeal of the 30-day requirement, if a U.S. Shareholder holds stock of a non-U.S. corporation that qualifies as a CFC — even if such qualification is only for one day during the taxable year — the U.S. Shareholder will be required to currently include in income its pro rata share of Subpart F income of the

[7] §958(b).

[8] *See* §951(a)(1) prior to the Act.

[9] Reg. §301.7701-3(c)(1)(iii). It should be noted that the check-the-box strategies, discussed herein, may give rise to adverse U.S. tax consequences to the extent that some or all of the underlying U.S. situs assets are U.S. real property interests, because, unlike gain on the disposition of stock or securities in a U.S. corporation (that are not U.S. real property interests), any gain recognized on the disposition or deemed disposition of a U.S. real property interest by a Canadian person (including a Canadian corporation, individual or ULC) generally is subject to U.S. tax.

[10] Note that unless the election to treat the ULC as a corporation is considered an initial check-the-box election made at the formation of the ULC, the ULC may be required to wait 60 months before making a subsequent check-the-box election. If, however, the election is an initial check-the-box election, the 60-month waiting period does not apply.

[11] Certain Canadian income tax rules applicable to trusts, such as the 21-year deemed disposition rule and attribution rules, are beyond the scope of this article.

[12] Reg. §301.7701-3(c)(1)(iii).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

CFC.[13] As a result, if the check-the-box election is effective even a few days after the death of the decedent, any gain in the U.S. stock or securities held by the ULC would be recognized on the deemed disposition resulting from the check-the-box election. While a ''high-tax kick out'' may generally be available,[14] generally Canadian tax planning would be implemented that would reduce or eliminate any gain in the securities giving rise to (i) Subpart F income, which the U.S. heirs would be required to include in income, and (ii) possibly a capital loss resulting from the basis increase in the CFC shares attributable to the Subpart F income inclusion, which capital loss would not be available to offset the Subpart F income inclusion. Such income inclusion could be significant if the U.S. stock or securities held by the ULC are highly appreciated.

Of course, the Subpart F income exposure could be addressed by making the check-the-box election of the ULC effective on a date prior to the date of death. As a result, the gain in the underlying U.S. stock or securities would be triggered prior to such time that the U.S. heirs are treated as owners of the ULC, and the underlying securities would get a basis step-up for U.S. tax purposes; however, a pre-death check-the-box election would result in U.S. estate tax exposure, because the decedent would be treated as owning the U.S. stock or securities through a Canadian pass-through entity, as opposed to a Canadian corporation, on the date of death. Whether a Canadian pass-through entity can serve as an effective blocker for U.S. estate tax purposes is a question of much debate.

ALTERNATIVE PLANNING STRUCTURES

The repeal of the 30-day requirement may have eliminated one common cross-border estate planning technique for Canada-based families holding U.S.-situs assets, but there are other methods through which the same U.S. estate and income tax goals can be achieved. These methods may, however, require some additional pre-death planning.

MULTI-TIERED HOLDING COMPANY STRUCTURE

One such alternative structure that should (i) protect against application of the U.S. estate tax, (ii) provide for a U.S. tax basis step-up in the U.S.-situs assets (e.g., the U.S. stock or securities), and (iii) avoid triggering any material Subpart F income that would be included in the income of the U.S. heirs, is a multi-tiered holding company structure.

Under this structure, the Canadian resident would hold, through a grantor trust, two top tier ULCs (''ULC-1'' and ''ULC-2''). ULC-1 and ULC-2 would form a lower-tier ULC (''ULC-3''), each holding 50% of the interests thereof.[15] All three ULCs will make initial check-the-box elections to be treated as corporations for U.S. tax purposes. ULC-3 will hold the stock or securities of a U.S. corporation. Upon the death of the Canadian resident, a check-the-box election will be made to treat ULC-3 as a pass-through entity for U.S. federal income tax purposes, which election will be effective prior to the date of the decedent's death. The deemed liquidation resulting from the check-the-box election will not qualify as a tax-free liquidation for U.S. federal income tax purposes, because the U.S. tax-free liquidation rules would require ULC-3 to liquidate into a corporate distributee holding at least 80% of ULC-3.[16] Here, because ULC-3 is held 50% by ULC-1 and 50% by ULC-2, the transaction will be a taxable transaction for U.S. tax purposes. Because the deemed liquidation of ULC-3 occurs prior to death, and therefore, prior to such time that any of the U.S. heirs are treated as direct or indirect owners of ULC-1, ULC-2, and ULC-3, no Subpart F income or U.S. income recognition should result from such deemed liquidation; however, the deemed liquidation will result in a basis step-up in the U.S. stock or securities for U.S. tax purposes.[17] Check-the-box elections can then be made for ULC-1 and ULC-2 with an effective date after the decedent's death. Although ULC-1 and ULC-2 may be CFCs at this time, assuming there has not been significant appreciation in the value of the U.S. stock or securities between the check-the-box election for ULC-3 and the check-the-box elections for ULC-1 and ULC-2, the deemed liquidations resulting from the subsequent check-the-box elections should not give rise to significant Subpart F income exposure.

Although this structure should mitigate the Subpart F income exposure with respect to any pre-death gain in the underlying U.S. stock or securities, due to the way a U.S. Shareholder's pro rata share of Subpart F income is calculated, there may be some U.S. tax leakage. Generally, a U.S. Shareholder's pro rata share of Subpart F income is based on the total amount of Subpart F income earned by a non-U.S. corporation for a taxable year multiplied by the ratio of (i) the total number of days in the taxable year for which the non-U.S. corporation was a CFC to (ii) the total number of days in the taxable year of the non-U.S. corporation.[18] Under this strategy, the check-the-box elections to treat ULC-1 and ULC-2 as pass-through entities should not have an effective date until at least one day after the decedent's death. As a result, because ULC-1 and ULC-2 would be treated as CFCs after the decedent's death until the upper-tier check-the-box elections are effective, it is possible

[13] §951(a).

[14] §954(b)(4).

[15] If the U.S. stock or securities are held through a Canadian corporation, then as with the strategy that was available prior to the repeal of the 30-day requirement (discussed above), prior to the death of the decedent, the Canadian corporation first will need to be converted to ULC-3.

[16] §332, §337.

[17] §334.

[18] §951(a)(2).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

that a sliver of any gain recognized by ULC-1 and ULC-2 on the deemed pre-death liquidation of ULC-3 would be allocable to the period in which ULC-1 and ULC-2 are CFCs held by the U.S. heirs, giving rise to a relatively small amount of Subpart F income and, potentially, a small amount of capital loss that cannot be used to offset such Subpart F income but may be offset against capital gains of the U.S. heirs.

DOMESTICATION TRANSACTION

Another alternative that may be considered to protect against U.S. estate tax while providing U.S. federal income tax efficiencies may be particularly beneficial when, at the time of death, (i) the U.S.-situs assets of the decedent are held through a Canadian corporation (which, as noted above, is an entity for which a check-the-box election to be treated as a pass-through entity is not available), (ii) the Canadian corporation is wholly owned by the decedent at the time of death, and (iii) the beneficiaries are all U.S. persons.

Under this alternative, following the decedent's death, the Canadian corporation would continue under Delaware law as a Delaware corporation. This type of transaction is referred to as a ''domestication transaction.'' At the time of the domestication, because the Canadian corporation will be owned by the U.S. heirs, based on the discussion above, the Canadian corporation would be a CFC. In general, the domestication of a CFC into the United States qualifies as a tax-free reorganization (known as an ''F'' reorganization),[19] pursuant to which the CFC is treated as transferring its assets to the acquiring U.S. corporation in exchange for the U.S. corporation's stock. A U.S. Shareholder of the CFC is treated as exchanging its CFC stock for the stock of the U.S. corporation.[20]

As a result of this deemed transaction, the U.S. Shareholder is required to include in income as a dividend the ''all earnings and profits amount'' with respect to the CFC stock deemed exchanged.[21] This refers to the CFC's net positive earnings and profits — generally determined in the same manner as the earnings and profits of a U.S. corporation — that are attributable to the U.S. Shareholder's stock.[22] However, as the U.S. Shareholder would be treated as holding the stock of the CFC only for the presumably short period from the decedent's death until the completion of the domestication transaction, the ''all earnings and profits amount'' should be relatively small.

Following the domestication transaction, the newly domesticated U.S. corporation could convert into a subchapter S corporation.[23] Although an S corporation generally is not subject to an entity-level tax on its income,[24] when a C corporation converts to an S corporation, any built-in gains at the time of the conversion must be recognized if the underlying asset is sold during the during the five-year period starting on the date of the conversion.[25] Therefore, the gain on any appreciation in the U.S.-situs assets (i.e., the underlying U.S. stock or securities) held by the domesticated C corporation immediately prior to the conversion to an S corporation can avoid recognition if the underlying U.S. stock or securities held by the S corporation is retained (i.e., not sold or exchanged) for at least five years following the conversion to an S corporation.

Based on the above, this strategy can be used to protect against U.S. estate tax, avoid any Subpart F income that would potentially arise on a post-death liquidation or deemed liquidation of a Canadian corporation, and provide a de facto step-up in the U.S. tax basis in the underlying U.S.-situs assets if the U.S. heirs are willing to wait five years following the conversion to an S corporation to dispose of the underlying U.S.-situs assets. For Canadian tax purposes, domestication[26] gives rise to a deemed disposition of the corporation's assets at fair market value. It also gives rise to a tax rate of 25%, reduced to 5% under the Treaty, on the difference between the fair market value of the property owned by the corporation net of liabilities and the paid up capital of its shares. Accordingly, this planning may not be tax efficient for Canadian tax purposes.

ADDITIONAL ALTERNATIVES

Certain additional cross-border estate tax planning strategies may be available depending on the specific facts and circumstances of the Canadian family and the U.S.-situs assets, including the following:

- Hold U.S.-situs assets through Canadian ULC treated as a partnership for U.S. tax purposes.
  - ♦ If U.S.-situs assets are held through a Canadian corporation, the conversion of the Canadian corporation to a ULC treated as a partnership for U.S. tax purposes, generally should not give rise to adverse U.S. tax consequences (assuming the Canadian corporation does not hold appreciated U.S. real property interests).
  - ♦ Receipt of ULC interests by U.S. heirs will not give rise to CFC and subpart F income tax consequences because the ULC will be treated as a partnership for U.S. tax purposes.
  - ♦ This structure does not provide U.S. estate tax protection for a Canadian resident holder of U.S.-situs assets. Subject to Canadian tax implications,

[19] §368(a)(1)(F).

[20] Reg. §1.367(b)-2(f).

[21] Reg. §1.367(b)-3.

[22] Reg. §1.367(b)-2(d).

[23] §1361.

[24] §1363.

[25] §1374.

[26] The combined effect of §250 of the *Income Tax Act* (Canada) and Article IV of the Treaty would see the continued corporation treated as a U.S. corporation for all domestic law and treaty purposes even if its mind and management remained in Canada.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

consider pre-death dispositions of U.S.-situs assets if there is not a significant amount of appreciation in such assets.

- Periodically dispose of and reacquire U.S.-situs assets held through Canadian corporation.
  - ♦ The disposition and reacquisition of the U.S.-situs assets may permit the Canadian corporation to hold such U.S.-situs assets with a U.S. tax basis at or near fair market value. A post-death liquidation of the Canadian corporation, at a time when the Canadian corporation is held by the U.S. heirs and treated as a CFC, should not give rise to significant subpart F income, because there should not be significant gain in the underlying assets.
  - ♦ If, however, the underlying assets are U.S. real property interests, this ''churning'' technique would give rise to adverse U.S. tax consequences.
  - ♦ Also need to consider Canadian tax consequences resulting from this strategy.

CONCLUSION

The Act, which generally became effective for tax years beginning after December 31, 2017, resulted in the most transformative changes to the U.S. system of taxation in the last 30 years. The Act's provisions — particularly those dealing with the international tax sections of the Code — are resulting in some expected and some unexpected consequences to international estate tax planning for Canada-based families with U.S. spouses and heirs.

At first blush, there was a concern that some of these consequences, including those relating to the repeal of the 30-day exception, would trigger significant adverse U.S. income and estate tax consequences for Canadian families holding U.S.-situs assets and their existing estate planning structures. Upon further review, many of the potentially adverse U.S. tax consequences to such Canadian families resulting from the provisions of the Act can be eliminated or at least mitigated with proper planning. Implementing a tax-efficient structure requires a full analysis of a Canadian family's existing investment structure, the extent of the U.S.-situs assets held by such family and the ultimate estate planning goals of the family. If there is one thing that is certain, the earlier that a Canadian family begins analyzing their U.S. estate tax structure (ideally, prior to the death of the Canadian resident family member that owns the assets), the greater the likelihood of developing a planning strategy to best protect the family's assets from adverse U.S. tax consequences.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

LEADING PRACTITIONER COMMENTARY

The New Enhanced Lifetime Exemption Under Most U.S. Estate Tax Treaties

By Thomas S. Bissell, CPA
Celebration, Florida

The dramatic increase in the lifetime estate and gift tax exemption level to $11.2 million (or to $22.4 million for a married couple) offers important tax planning opportunities for many aliens who are domiciled in a country that has an estate tax treaty with the United States. For aliens whose worldwide net worth is below the new $11.2 million threshold (or whose family net worth is less than $22.4 million if they are married and domiciled in a country whose treaty with the United States allows a marital deduction), it may no longer be necessary to protect themselves from U.S. federal estate tax (''FET'') by utilizing a non-U.S. holding company or an appropriately structured trust. The only drawback for those aliens who decide to eliminate an existing structure in order to hold U.S. assets in their individual names (apart from any potential tax cost in getting out of an existing structure) is that the new thresholds are scheduled to revert to $5 million and $10 million thresholds (before inflation adjustments) that existed in 2017. But even if that happens, those lower thresholds may still be high enough to exempt many of the same individuals from FET.

For many years, the exemption level on the estate of a deceased non-domiciled alien (called a ''nonresident not a citizen of the United States''[1]) has been ''stuck'' at $60,000 (a unified credit of $13,000) on the decedent's U.S.-situs property, as defined in §2104. Although Congress in 2017 very generously increased the lifetime exemption to $11.2 million, it made no change to the $60,000 exemption for non-domiciled aliens that has been in effect for decades. Thus, to the extent that the value of the decedent's U.S.-situs property (after allowable deductions) exceeds $60,000, FET is still imposed starting at the rate of 24% and increasing to 40% on the value of the taxable estate in excess of $1 million. If no relief from FET is available under a tax treaty with the United States and if the resulting estate tax is more than can be fully credited against the death tax (if any) imposed on the same U.S. assets by the decedent's home country, many aliens who are properly advised will arrange to hold their taxable U.S.-situs assets through a properly structured non-U.S. holding company or nongrantor trust.[2] Although such a structure is usually effective to avoid FET, the structure can often cause income tax complications in the alien's country of residence and sometimes also under the U.S. income tax laws — both for the alien investor and for the investor's heirs.

Non-domiciled aliens who invest in the United States primarily hold three kinds of assets: stock (equities) in publicly traded U.S. companies, publicly traded bonds and notes (debt obligations of U.S. obligors, including U.S. bank deposits), and U.S.-situs real property (typically vacation homes, rental property, or second homes rented out part-time). The first and third categories are subject to FET upon the death of the alien investor, but the second category (debt obligations of U.S. persons) is usually exempt from FET under §2105(b).

'Domicile' and 'Situs' Treaties

If the alien investor is domiciled in a country that has a post-1970 estate tax treaty with the United States, stock in U.S. companies is exempt from FET (no matter how high their value). Sometimes referred to as ''domicile'' treaties or ''broad'' treaties, these include treaties with Austria, Denmark, France, Germany, the Netherlands, and the United Kingdom.[3] However, no FET exemption for stock in U.S. companies is available under the pre-1971 estate tax treaties (sometimes called ''situs treaties'') — those with Australia, Finland, Greece, Ireland, Italy, Japan, South Africa, and Switzerland — or under the estate tax provisions in Article XXIX.B of the 1980 Canada-U.S. income tax treaty, which more closely resembles the pre-1971 U.S. estate tax treaties than most of the ones that entered into force after 1970.

However, under many treaties — six of the eight pre-1971 treaties,[4] three of the six post-1970 treaties,[5] and the Canada-U.S. income tax treaty — an en-

---

[1] §2101(a). This term is very different from ''nonresident alien,'' which is an income tax concept defined in §7701(b). Residence of a non-U.S. citizen (i.e., an alien) for U.S. transfer tax purposes is based on where the individual is ''domiciled,'' under Reg. §20.0-1(b). In order to avoid confusion, this article uses the term ''non-domiciled alien'' and not ''nonresident alien.''

All section references are to the U.S. Internal Revenue Code, as amended (''the Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[2] *See generally* T. Bissell, 903 T.M., *Tax Planning for Portfolio Investment Into the United States by Foreign Individuals*.

[3] For a detailed discussion of the tax treaty issues discussed in this article, see Schoenblum, 6896 T.M., *U.S. Estate and Gift Tax Treaties*.

[4] The U.S. estate tax treaties with Austria, Finland, Greece, Italy, Japan, and Switzerland. The pre-1971 treaties with Ireland and with South Africa do not include an enhanced lifetime exemption.

[5] The treaties with France, Germany, and the United Kingdom include an enhanced lifetime exemption. The treaties with Austria, Denmark, and the Netherlands do not. It is unusual to find the enhanced exemption in any post-1970 treaties, because the 1980 U.S. model estate and gift tax treaty does not include an enhanced lifetime exemption. However, the Treasury's model treaty is somewhat academic because there have been no new U.S. estate tax treaties since the 1980s, and no protocols have been added to existing treaties since the French protocol in 2004 and the Canadian protocol in 2007.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

hanced lifetime exemption (unified credit) is available based on the ratio of the decedent's U.S.-situs ''gross estate'' to his or her worldwide gross estate. The effect of the enhanced lifetime exemption can be to provide a de facto FET exemption with respect to U.S. equities under the pre-1971 treaties and the Canada-U.S. income tax treaty, and/or a de facto FET exemption with respect to U.S.-situs real property under all of the treaties that provide for an enhanced exemption — provided, of course, that the decedent's worldwide gross estate is below the current $11.2 million exemption amount (or below $22.4 million, if the treaty allows a marital deduction).

As an example, assume that a non-domiciled alien in one of these 10 countries dies owning $10 million of worldwide assets, of which $7 million is U.S.-situs property held at death in the decedent's individual name. Because the decedent's worldwide gross estate is less than $11.2 million, the entire $7 million of U.S.-situs property is exempt from FET. Under the six pre-1971 treaties that contain an enhanced exemption and the Canada-U.S. income tax treaty, the U.S.-situs property might consist of U.S. equities, U.S.-situs real property, or some combination of the two — all of which would otherwise be subject to FET under the Code to the extent that its value exceeded $60,000. Under the three post-1970 treaties that contain the enhanced exemption (France, Germany, and the United Kingdom), the U.S.-situs property might consist entirely of U.S.-situs real property, because those treaties otherwise exempt U.S. equities from FET.

What is not entirely clear under all of the treaties that contain the enhanced exemption, however, is whether debt obligations of U.S. obligors that are exempt from FET because they are defined to be non-U.S. situs (in §2105(b)) must be counted in the denominator of the enhanced exemption fraction. Nor is it entirely clear that U.S. equities that are subject to FET under the Code but exempt from FET under the France, Germany, and U.K. treaties must be counted in the denominator. Presumably the answer is yes, because §2102(b)(3)(A) provides that in calculating the unified credit allowed to the estate of a nondomiciled alien, property shall not be treated as U.S.-situs if it is exempt from FET under the Code or under an estate tax treaty. This provision does not, however, require those items to be excluded from the denominator. Presumably, therefore, if the facts in the above example were changed so that at death the decedent owned $14 million of worldwide assets, of which $6 million were U.S. equities, $1 million was U.S. real property, and the $7 million balance was foreign-situs property, some FET would be imposed under all 10 of the enhanced-exemption treaties on the $1 million of U.S. real property because the decedent's worldwide estate would exceed the $11.2 million lifetime exemption for U.S. citizens and U.S.-domiciled aliens. In addition, some FET would be imposed on some of the U.S. equities under all of the treaties except those with France, Germany, and the United Kingdom, because the gross estate after reduction for the U.S. real property would still be $13 million — that is, more than the $11.2 million enhanced exemption amount.[6] However, if the $1 million of U.S. real property were held through a properly structured non-U.S. company or nongrantor trust, FET on that property could probably be avoided under all of the treaties. Similarly, the U.S. equities under the pre-1971 treaties would be exempt from FET if they were held through such a vehicle.

Ownership in One's Own Name?

For non-domiciled aliens who own U.S.-situs real property, owning the property in his or her individual name can often be preferable to the traditional structure of owning the property through a non-U.S. corporation. Although the reduction in the federal corporate tax rate to 21% can result in the taxation of rental income at a rate lower than individual tax rates, the individual capital gains rate is still lower than the 21% corporate tax on capital gains (plus potential state income tax, which may be higher than the state's individual tax rates). A non-U.S. corporation can also be exposed to branch tax on its after-tax profits under §884, and upon the death of the alien who owns the holding company, the tax-free step-up in the basis of the real property that would occur under §1014 if the alien owned the property individually would not occur. If the alien already owns U.S. real property through a non-U.S. holding company and wishes to liquidate the company in order to hold the property in individual name, however, any gain on the liquidation would be taxed under §897.

If the non-domiciled alien now owns publicly traded U.S. equities through a non-U.S. holding company and wishes to liquidate the company in order to hold them in his or her individual name, in most cases no U.S. tax would be imposed on any gain realized from the liquidation — although the alien might obviously be subject to tax on the gain in his or her country of residence. Again, holding the equities in individual name would result in a §1014 step-up in the basis of appreciated securities at death — a result that may be important to the extent that some of the alien's heirs are U.S. persons.

Although holding U.S.-situs property in an alien's individual name may result in a FET saving (and thus, in many cases, in a worldwide tax saving), some aliens may be reluctant to hold U.S. property in their individual name, for privacy reasons. In order to claim the enhanced exemption, the alien's estate must file Form 706NA and disclose all of the alien's worldwide assets. However, because all of the treaties containing the enhanced exemption are with OECD countries that have highly developed economies and efficient tax administrations, it can be assumed that most aliens and their estates will be in compliance with

[6] Because of the broad exemption in the France, Germany, and U.K. treaties for U.S. equities (other than stock in a real property holding company, under the French treaty), the $6 million of U.S. equities would be exempt from FET, whether or not the enhanced exemption resulted in a FET exemption on the U.S.-situs real property.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

their home country's tax laws, so that most estate executors will not be concerned about the possibility that the IRS might transmit information from a decedent's Form 706NA to the decedent's home country under the exchange-of-information provisions of the applicable treaty.

Apart from the privacy issue noted above, it is perhaps understandable that many non-domiciled aliens who can benefit from the enhanced exemption in a treaty have not yet placed their U.S.-situs taxable assets into their individual name. In the 1990s the lifetime exemption for U.S. citizens and domiciled aliens was only $600,000, and although the exemption level was gradually increased in the early 2000s, there was a concern that the exemption level would revert back to $600,000 in 2010. Congress in 2013 restored the exemption permanently to an inflation-adjusted $5 million, where it has remained until 2018. Under the new law, the "reversion problem" exists once again, but so far with a "floor" of an inflation-adjusted $5 million. Although it is certainly impossible to predict what Congress will do in the coming decades, for the time being it may be safe to assume that Congress will retain the $5 million floor indefinitely.[7]

Top Ten Reasons To Limit §958(b)(4) Repeal

By Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

As is by now well known, in the 2017 tax reform act, previously known as the Tax Cuts and Jobs Act,[1] Congress excised §958(b)(4) from the Internal Revenue Code.[2] Section 958 in general provides attribution and constructive ownership rules for purposes of determining who is considered to own stock of a foreign corporation, potentially making a U.S. person a 10% shareholder within the meaning of §951(b) (an "inclusion shareholder") and potentially making a foreign corporation a "controlled foreign corporation" (CFC) within the meaning of §957. Section 958(b)(4) had blocked downward attribution of ownership from a foreign person to a U.S. person down the chain. So, for example, if a foreign parent corporation owned 100% of the stock of both a U.S. and a foreign subsidiary, the parent's stock in the foreign subsidiary would not be attributed down to the U.S. subsidiary under §318(a)(3)(C) so as to make the foreign subsidiary a CFC. After the repeal of §958(b)(4), the foreign subsidiary would be a CFC.

It is understood that in repealing §958(b)(4), Congress was targeting a structure sometimes seen following inversions, in which a foreign person acquires stock of a U.S. corporation that itself owns preexisting CFCs. Some taxpayers may have tried to "de-CFC" those historic CFCs by issuing enough stock to the new foreign parent such that the historic CFCs were no longer controlled by the acquired U.S. corporation. However, the repeal of §958(b)(4) sweeps far more broadly than that type of structure. Apparently realizing this, Senators David Perdue (R-Ga.) and Orrin Hatch (R-Utah) placed into the Congressional Record the following colloquy:

> (Perdue) I would like to confirm my understanding of the modification of the section 958(b) stock attribution rules contained in the Tax Cuts and Jobs Act. The Senate Finance Committee explanation of this bill, as released by the Senate Budget Committee, definitively states, "This provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under section 318(a)(3) to a U.S. person that is not a related person (within the meaning of Section 954(d)(3)) to such U.S. shareholder as a result of the repeal of section 958(b)(4)." I would like to confirm that the conference report language did not change or modify the intended scope this statement. As you know, I filed an amendment to the Senate bill, Senate amendment No. 1666 would have codified this explanatory text of the Finance Committee report. I also want to confirm that the Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill.
>
> (Hatch) The Senator is correct. The conference report language for the bill does not change or modify the intended scope of the statement he cites. The Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee. I would also note that the reason his amendment No. 1666 was not adopted is because it was not needed to reflect the intent of the Senate Finance Committee or the conferees for the Tax Cuts and Jobs Act. I thank my friend from Georgia for his leadership on this issue to ensure that the stock attribution rules operate consistent with our intent and do not result in unintended consequences. I look forward to continuing to work with him on this important issue.

---

[7] The only cautionary note is that during the closing years of the Obama Administration, its annual proposals for tax reform recommended reducing the lifetime exemption to $3.5 million, which had been the amount in 2009. The 2016 Democratic Party platform included the same recommendation, as well as a proposal to increase the rate on large estates to as high as 65%.

[1] Pub. L. No. 115-97.

[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended ("the Code").

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

If the intent laid out in the colloquy were in fact the law, the issues described below would not be problematic. But the statute is not so limited, and Senator Hatch's statement that no legislative fix was needed is incorrect. Unless Treasury and the IRS can muster the courage to reach for regulatory authority to fix the problem based on the evident congressional intent, the result will be to treat as CFCs a wide range of foreign corporations that are not controlled by U.S. persons in any normal sense.

To encourage Treasury and the IRS to find their authority, or to spur Congress to fix this mistake, this article sets out my ''top ten'' list of things that will go terribly wrong if §958(b)(4) repeal is left unlimited. The list has been limited to 10 due to space constraints — a complete list would take a book. My list in fact builds upon two prior articles in this space by Edward Tanenbaum.[3]

1. *Subpart F Generally.* A faux CFC will be a CFC for all purposes of subpart F and the new GILTI[4] rules of §951A. Many of the untoward consequences of this are described in Edward Tanenbaum's previous articles. Note that some of the results may be taxpayer favorable; for example, a U.S. shareholder that sells stock of the faux CFC will have dividend income to the extent provided by §1248. Subpart F and GILTI inclusions, including pursuant to the transition tax in §965,[5] will give rise to positive basis adjustments under §961 and to previously taxed income (PTI). Given the ability to spread the §965 tax over eight years without interest, that basis and PTI will create arbitrage opportunities.

2. *Section 312(m).* Section 312(m) prohibits a downward adjustment to earnings and profits (E&P) of a foreign corporation that pays interest on an obligation that fails to meet the registration requirements of §163(f). There is an exception to this rule for a foreign corporation that is not a CFC and did not have a tax-avoidance purpose. If a foreign corporation is a CFC, it will be subject to the general rule, regardless of its purpose. This rule, of course, presupposes that a CFC is actually controlled by U.S. persons who should know better. The rule will have knock-on effects in determining the E&P of these faux CFCs taken into account under subpart F.

3. *Individual Expatriations.* Section 877 provides punitive tax rules for U.S. citizens or long-term green card holders who give up their status as such. Two rules in this section, §877(d)(1)(C) and §877(d)(4), come down especially hard on expatriates who own or form CFCs. That makes sense, given that these U.S. taxpayers are attempting to defer income through a controlled foreign corporation. But if it's only a faux CFC, in which the expatriate might own only a de minimis amount of stock, the equities start to look murkier.

4. *Subpart F Insurance Income.* The definition of a CFC for purposes of §953 was already wider than that of subpart F generally, but the repeal of §958(b)(4) will make it even more so. Under §512(b)(17), a U.S. tax-exempt organization can be subject to the unrelated business income tax if it is a shareholder of a CFC that has insurance income. It's difficult to believe that Congress intended to widen the UBTI net by repealing §958(b)(4).

5. *International Shipping and Aircraft Income.* Section 883 generally exempts income earned by foreign corporations from international ships and aircraft so long as the foreign corporation in question resides in a country granting U.S. carriers an equivalent exemption, and the foreign corporation is not ''treaty shopping.'' Section 883(c)(2) turns off the treaty shopping restriction for CFCs.

6. *PFICs — Basic Test.* Under §1297(d), a foreign corporation that is a CFC as to any U.S. inclusion shareholder cannot be a PFIC. The repeal of §958(b)(4) comes as a welcome relief to a number of U.S. shareholders (including some that may be caught even by the narrower rule Congress evidently intended to adopt) that sought to avoid the dreaded PFIC regime but could not otherwise qualify their foreign corporations as CFCs.

7. *Pop-Up PFICs.* A foreign corporation can be a PFIC with respect to less than 10% shareholders and a CFC with respect to 10% or greater shareholders. Under §1297(e)(2), if the foreign corporation is a CFC (and not publicly traded), it is required to apply the PFIC asset test of §1297(a)(2) by reference to the adjusted basis, rather the fair market value, of its assets. The use of adjusted basis will, in many cases, cause the corporation to be treated as a PFIC where it would not have been so treated had the fair market value test applied.

8. *PFIC Parent, CFC Sub.* Recall the simplest example of a faux CFC — a foreign subsidiary of a foreign parent that just happens to own a U.S. subsidiary. The results in such a case will usually be merely annoying, such as having to file CFC

[3] *See* Tanenbaum, *The 2017 Tax Act: CFCs — The More the Merrier?* 47 Tax Mgmt. Int'l J. 202 (Mar. 9, 2018); *Downward Attribution CFCs*, 47 Tax Mgmt. Int'l J. 341 (May 11, 2018).

[4] Global low-tax intangible income.

[5] The repeal of §958(b)(4) was made retroactive to taxable years of foreign corporations beginning before January 1, 2018. It therefore radically altered the scope of §965, which had the same effective date.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

returns under §6038.[6] But it is possible that the foreign parent in such a case might be a PFIC as to some U.S. shareholders, with results too bizarre to detail here.

9. *Eligibility for §245A Deduction.* Dividends from a PFIC do not qualify for the §245A deduction, but dividends from a CFC do. Where the repeal of §958(b)(4) causes a foreign corporation that would otherwise have been a PFIC to become a CFC in the hands of a U.S. shareholder, a U.S. shareholder that is a corporation will be allowed the deduction.

10. *Portfolio Interest.* Section 881(c)(3)(C) and §881(c)(5) impose significant limitations upon the portfolio interest exemption as applied to interest received by CFCs. The policy behind these rules is not implicated in the case of a faux CFC.

This list has only scratched the surface. It is worth stepping back and asking why so many Code provisions that speak in terms of CFCs make no policy sense after the repeal of §958(b)(4).

Downward attribution makes sense where one is trying to define a related group of domestic entities. But in the cross-border context, most rules of the Code draw sharp distinctions between ''outbound'' and ''inbound'' ownership structures. We think of ''outbound'' cases as those in which a U.S. parent or group of U.S. shareholders invests in a foreign corporation. The rules applicable to this set of cases are found largely in subchapter N of the Code and in the PFIC provisions. Conversely, an inbound case is where a foreign corporation or group invests in a U.S. corporation. Because the United States has only limited taxing jurisdiction over foreign persons, the inbound rules are narrower in scope, and scattered throughout the Code. The major rules are found in the definitions and withholding tax rules for FDAP and in the effective connection rules of §864.

Allowing downward attribution from a foreign person to a U.S. person in order to make the U.S. person a deemed shareholder of another foreign affiliate confuses inbound and outbound paradigms that have been constructed over many years. Repeal of §958(b)(4) is not the first time that Congress has let its obsession with inversions cloud its understanding of how the Code's international rules fit together. The repeal should be repealed, and if it is not, Treasury should exercise its authority as far as it can to undo the damage.

[6] This requirement was wisely turned off by §5.02 of Notice 2018-13, suggesting that the IRS has authority to disregard the repeal of §958(b)(4) where another provision of the statute grants it wide regulatory discretion.

Update on OECD Transfer Pricing Guidance

By David Ernick
PricewaterhouseCoopers LLP
Washington, D.C.

After a few months to absorb the changes to U.S. transfer pricing rules resulting from the 2017 tax reform act, it is time to turn to the OECD's transfer pricing agenda. And as usual, attention must be paid.

Attribution of Profits to Permanent Establishments

The most recent guidance from the OECD relating to transfer pricing issues was the March 22, 2018, release of a final report containing additional guidance on attribution of profits to permanent establishments.[1] The Profit Attribution Report sets forth ''high-level'' principles for attributing profits to permanent establishments (PEs). It provides general guidance for attribution of profits to PEs related to fragmentation of activities and commissionaire structures, as well as possible approaches that jurisdictions may adopt for administrative simplification. The report also includes four (very general) examples of how, in practice, profits should be attributed to PEs.

Upon reading through the report, however, it is difficult to find any guidance that is even ''high-level.''[2] The report essentially consists of a very brief summary of the AOA (the Authorized OECD Approach for Attributing Profits to PEs), including that the attribution of profits to a PE should be the profits that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE. Despite requests from commentators, the report does not take a formal position on whether Article 9 or Article 7 of the Model Tax Convention should apply first (note, though, that all of the examples apply Article 9 first).

Additionally, the report does not incorporate the recommendation from commentators that countries adopt simplified methods, such as actually collecting tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) PE. That is disappointing, as the burdens of filing PE tax returns can be significant. The examples have been improved since the earlier discussion draft, although they are still too conclusory to be useful in practice. They do not contain any numbers, which seems un-

[1] Available at www.oecd.org.

[2] ''High-level'' seems to be the OECD's preferred term to use when the relationship between the guidance provided and its intended purpose is unclear. For example, remember the OECD's description of country-by-country (CbC) reporting as being useful in conducting a ''high-level'' transfer pricing risk assessment; no explanation has yet been offered as to how CbC reporting can be appropriately utilized in a transfer pricing system based on the arm's-length principle.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

usual in a document intended to provide guidance on determining the amount of profits attributable to a PE. Also, no indication of the report's status is provided — it does not seem to amend either the 2010 AOA Report or the 2017 Model Tax Convention.

One important point that might be easy to miss is contained in the report's foreword, which indicates that it is issued by the OECD's "Inclusive Framework on BEPS," which already includes more than 100 member countries (and is still growing). That is the OECD's new operating format in its project to implement its BEPS recommendations, allowing all countries (not just its 35 member countries) to participate in the OECD's tax work. That likely explains the extremely general nature of the report; attribution of profits to PEs is an esoteric area of international tax law to begin with, and getting consensus from more than 100 countries to provide any details on this topic seems almost impossible. That feature of the Inclusive Framework may result in a similar lack of detail in the OECD's forthcoming transfer pricing guidance, discussed below.

Expected Release of Additional Transfer Pricing Guidance

Two other discussion drafts were due to be finalized this spring. First, it was rumored that the final version of the June 22, 2017, discussion draft, "Revised Guidance on Profit Splits" would be released as early as May of this year. (The annual OECD International Tax Conference is scheduled for this month in Washington, D.C., so it would not be at all surprising to see publication of this report, and perhaps others, immediately before, so that the panelists would have some new material to cover.) The discussion draft seemed to put a thumb on the scale for making the profit split method almost the default best pricing method. The use of subjective terminology like "highly integrated" as the touchstone for use of the profit split method (PSM) was troublesome, as it increased the risk of arbitrary application of the PSM by tax authorities. The use of assorted synonyms for "highly integrated") (e.g., "interlinked," "highly interrelated," "interdependent," "a high degree of interdependency") was not helpful, as it did nothing to outline the dividing line between the integration which exists in "most" multinational groups and the "particularly high degree of integration" purported to justify application of the PSM. Hopefully the final report on use of the profit split method returns to the traditional test of when it is the most reliable method — whether each of the parties to a controlled transaction contributes unique or valuable intangibles.

Also due to be finalized shortly was the May 23, 2017, discussion draft, "Implementation Guidance on Hard-to-Value Intangibles." That draft defined hard-to-value intangibles (HTVI) as those intangibles for which, at the time of their transfer in a transaction between associated enterprises, (i) no reliable comparable existed, and (ii) the projections of future cash flows or income expected to be derived from the transferred intangible or the assumptions used in valuing the intangible were highly uncertain. The definition was criticized as being so subjective that almost any intangible could be characterized as "hard-to-value." The use of ex post information (which would have been unavailable to unrelated parties negotiating prices at the time of the transaction) to reassess arm's-length pricing years after the initial transfer was a clear violation of the arm's-length principle, and not consistent with the authority granted to tax administrations under tax treaties.

Also noted was the fact that the first two examples in the draft used as factual predicates the assumption that at the time the transactions were entered into, the projections of future cash flows or income expected to be derived from the transferred intangible were highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. In the calculation of the HTVI adjustments in both of the examples, however, an "income method," based on the discounted value of projected income or cash flows, was used to make ex post transfer pricing adjustments. It will be interesting to see how the final version of this draft resolves that inherent contradiction — that the intangibles were "hard to value" because cash flows could not be reliably predicted, yet the income method was the best pricing method, even though that method requires accurate projections of future cash flows in order to be reliable.

In terms of new discussion drafts, we are also awaiting the release of draft guidance on financial transactions. The OECD does not appear to have discussed this topic publicly in depth since its last International Tax Conference, in June 2017. Topics potentially covered include financial and performance guarantees, derivatives, captive and other insurance arrangements, pricing of intragroup loans, hedging arrangements, and cash pooling. This draft is intended to result in a new chapter to the Transfer Pricing Guidelines, although handling even a few of these topics comprehensively could be a daunting task for the OECD, especially given the difficulties noted above in gaining consensus while operating through the Inclusive Framework.

Also, the OECD stated previously that this guidance would be based on applying the arm's-length principle to funding transactions within a group. That raises its own difficulties, as recent experience in the United States and elsewhere indicates that tax authorities are not comfortable relying solely on the arm's-length principle to police financial transactions, but instead seek to backstop transfer pricing rules with bright-line anti-base erosion rules and/or anti-abuse rules. But it may be difficult for the OECD to say much in that respect, as Working Party No. 6 would be going outside its mandate to the extent it makes recommendations beyond the contours of the arm's-length principle.

Invitation for Public Comments in Scoping Possible New Projects

Finally, the OECD has also recently released (on May 9) two requests for public comments. The first deals with a proposal to revise the guidance in Chap-

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

ter VII of the Guidelines on intragroup services.[3] The request notes that Chapter VII has been largely unchanged since 1996, and in particular has not been updated to incorporate the guidance developed under BEPS Actions 8–10. That sounds a little ominous; perhaps it is intended that the so-called ''DEMPE functions''[4] analysis from the Actions 8–10 report will also be incorporated into Chapter VII.

The request for comments also includes assessing the arm's-length conditions for services provided in connection with the use of intangibles, services that are highly integrated with the value creation of the multinational group, and/or involve significant risks. That seems like it could be another vehicle to expand the use of the aggregation principle and the income method as the best pricing method, as recently favored by both the OECD and the IRS. The request also identifies as issues that may be covered (1) demonstrating that a service has been rendered and/or that it provides benefits to the recipient, and (2) identifying in practice duplicated activities. Those would seem like pretty straightforward factual issues for which not much guidance would be needed. However, tax authorities seem to be more frequently disallowing deductions for services on the ground that they have not actually been rendered, or, if they have, they do not provide a benefit or are duplicative. We will have to wait and see if there is a discussion draft and, if so, whether it is neutral on these issues or if it uses those justifications to express skepticism of deductions for services costs.

The second request for comments is with respect to Chapter IV of the Guidelines, dealing with ''Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes.''[5] The request notes up front that there is no need to revise the current guidance on safe harbors and arbitration — apparently because those topics have already been addressed relatively recently by OECD guidance. Perhaps that is true, although it seems like more could be done to improve countries' actual implementation of that guidance. The take-up on the arbitration provisions from BEPS Action 14 in the Multilateral Treaty Instrument was not nearly as great as had been hoped. Similarly, with respect to safe harbors, the May 13, 2013, revisions to Chapter IV of the Guidelines[6] seems to have been widely ignored, especially the very useful sample memoranda of understanding for competent authorities to establish bilateral safe harbors.

This request for comments does not identify any other options that could serve to avoid and resolve transfer pricing disputes. Although country by country reporting is widely expected to be the source of many more transfer pricing and permanent establishment disputes,[7] presumably requests to abolish it will not be entertained. The uncertain, subjective nature of the guidance in the Transfer Pricing Guidelines after the amendments made by the Final Actions 8-10 report is also expected to lead to many more transfer pricing disputes, as will the divergent interpretation and application of that guidance by tax authorities.

Conclusion

This quick review of the OECD's current transfer pricing work program reveals it to be much fuller than I would have expected less than three years after issuance of the final BEPS reports. That is particularly the case given that the transfer pricing changes as part of the BEPS project were so significant. And at the time, the OECD stated that it had done all that was needed to ensure that transfer pricing outcomes better align with the ''value creation'' of the multinational group, and that ''the goals set by the BEPS Action Plan in relation to the development of transfer pricing rules have been achieved.''[8] It is not immediately clear what has changed so quickly, if all the goals related to transfer pricing guidance had been achieved back in September 2015, but now once again need revision.

But despite the full agenda it is not a foregone conclusion that we will see final, consensus changes to the Transfer Pricing Guidelines any time soon. A sense of fatigue seems to have set in at Working Party No. 6, especially without the urgency of an artificial deadline to finish as we had with the BEPS project. And very recently (May 17) the OECD posted a job opening for a new Head of Division — Tax Treaty, Transfer Pricing and Financial Transactions.[9] Certainly that vacancy may slow down the process, until a new official to fill that position is recruited, in place, and up to speed on the responsibilities of the role.

But perhaps the biggest impediment to significant changes to the Transfer Pricing Guidelines may be the OECD's new post-BEPS framework for conducting its tax work — the Inclusive Framework. I have written about this topic previously, but suffice it to say that the essential tension of that model remains. Allowing more countries to participate in the OECD's tax work potentially makes it more likely that countries will actually implement the OECD's recommendations. But having more than 100 countries around the table at the OECD's conference center in Paris makes it incredibly difficult to achieve consensus at any meaningful level of detail. That certainly seems to have been the case with the recent final report on attribution of profits to PEs.

[3] Available at www.oecd.org.

[4] Development, Enhancement, Maintenance, Protection, and Exploitation. An analysis of DEMPE functions seems to be all the rage now; I am seeing tax authorities routinely ask for this type of analysis while apparently disregarding things like legal ownership of intangibles, assumptions of risk, and provision of capital.

[5] Available at www.oecd.org.

[6] Available at www.oecd.org.

[7] The OECD foresees these disputes as well, and recently established a new pilot program, the ''International Compliance Assurance Program,'' to attempt to handle all the expected disputes.

[8] See the Executive Summaries of the Final BEPS Reports at page 30, available at www.oecd.org.

[9] Available at https://oecd.aleo.net.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

Subpart F and the BEAT

By Lowell D. Yoder, Esq.
McDermott Will & Emery LLP
Chicago, Illinois

New §59A imposes a 10% minimum tax on domestic corporations that make substantial amounts of deductible payments to related foreign persons.[1] The new tax is referred to as the ''base erosion and anti-abuse tax,'' or the ''BEAT.'' This article explores the interaction between the BEAT and Subpart F of the tax code.

The BEAT

The BEAT is calculated as 10% of *modified* taxable income less the regular tax liability (reduced for certain tax credits).[2] The BEAT calculation apparently is performed on a U.S. consolidated group basis.[3]

A corporate taxpayer's modified taxable income is calculated by adding back to regular taxable income current year deductions involving payments to related foreign persons[4] and the base erosion percentage of any net operating loss deduction allowed for the taxable year.[5] The amounts added back generally include payments for services, interest, rents, and royalties.[6] Deductions for depreciation and amortization of property acquired from related foreign persons also are added back to regular taxable income in calculating modified taxable income.[7]

No amount generally is added back for payments to related foreign persons that reduce a taxpayer's gross receipts. This includes payments for costs of goods sold and may apply to certain procurement commissions and other payments that are included in costs of goods sold.[8] In addition, an exception is provided for services that are eligible for a modified version of the services cost method under the §482 regulations, to the extent that the amount in question constitutes total services costs, with no mark-up component.[9] Another exception is provided for certain qualified derivative payments.[10]

Modified taxable income is multiplied by 10%,[11] and that minimum tax amount is compared with the regular tax liability of the taxpayer. The regular tax liability generally is reduced by various credits, including foreign tax credits.[12] Research and development credits and 80% of certain other §38 credits, however, do not reduce regular tax liability.[13]

If the above minimum tax amount exceeds the regular tax liability (net of certain tax credits), then the excess amount is an additional tax imposed on the taxpayer. Unlike the former alternative minimum tax rules, there is no provision for a carryover of the BEAT as a reduction of regular tax liability in future years.

Many U.S.-based multinational groups will not be subject to the BEAT under a *de minimis* exception. If the total amount of deductions added back to compute modified taxable income is less than 3% of total deductions (2% for certain banks and securities dealers)

---

[1] The BEAT generally applies to domestic corporations and to foreign corporations with income effectively connected with a U.S. trade or business. The BEAT, however, does not apply to corporations with annual gross receipts for the three-taxable-year period ending with the preceding taxable year of less than $500 million. §59A(e)(1)(B).

All section references are to the Internal Revenue Code of 1986, as amended.

[2] §59A(b)(1). The rate is 5% for 2018, and increases to 12.5% beginning in 2025. §59A(b)(1)(A), §59A(b)(2)(A). These rates are increased by one percentage point for certain banks and securities dealers. §59A(b)(3). The regular tax liability is reduced for all tax credits beginning in 2025. §59A(b)(2)(B).

[3] While §59A does not explicitly provide that the BEAT is calculated on a consolidated group basis, it is anticipated that the Treasury will issue guidance providing for this treatment.

[4] For this purpose, a foreign person is related if it is considered as owning at least 25% of the stock of the taxpayer (by vote or value) or satisfies various other relationship or control tests (generally greater than 50% ownership) with respect to the taxpayer or any 25% owner of the taxpayer. §59A(g).

[5] §59A(c)(1)(B). The base erosion percentage is generally the aggregate amount of deductible payments to related foreign persons divided by all other deductions. §59A(c)(4).

[6] §59A(c)(1)(A), §59A(d)(1). The amount of a deductible payment that is added back in calculating modified taxable income is reduced if subject to U.S. withholding tax. §59A(c)(2)(B)(i). If the amount of a deduction for interest is limited by §163(j), the reduction in the amount of deductible interest is allocated first entirely to interest on loans from unrelated persons. §59A(c)(3).

[7] §59A(d)(2). This applies only to property purchased during taxable years beginning after December 31, 2017.

[8] *See* §263A (certain direct and indirect costs included in inventory costs). This rule does not apply to ''expatriated entities.'' §59A(c)(2)(A)(iv), §59A(d)(4).

[9] §59A(d)(5). Eligibility for the services cost method for this purpose is determined without regard to the regulations' requirement that the services not contribute significantly to the fundamental risks of business success or failure. *See* Reg. §1.482-9(b). Based on the statute and legislative history (including a floor colloquy between Senators Hatch and Portman), in many cases it may be possible to bifurcate service fees into cost and mark-up components, with the BEAT applying only to the mark-up component. Indeed, the application of the services cost method without regard to one of its key requirements necessarily means that the Congress intended to apply the exception for BEAT purposes even in situations in which arm's-length pricing would necessitate a mark-up. *See* Corwin, Dabrowski, Plowgian, Rolfes, and Wessel, *A Response to an Off-Beat Analysis*, Tax Notes p. 933 (Feb. 12, 2018); Bates, McDonald, and Vidano, *BEAT and Low-Margin Services: Much Ado About No Markup*, 37 DTR 17 (Feb. 23, 2018).

[10] §59A(h).

[11] *See* n.2, above.

[12] §59A(b)(1)(B)(i).

[13] §59A(b)(1)(B)(ii), §59A(b)(4). Beginning in 2025, these credits will also reduce regular tax liability for purposes of calculating the BEAT. §59A(b)(2)(B).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

used in calculating taxable income, then the BEAT does not apply.[14]

Interaction of Subpart F and the BEAT

There are limited rules coordinating the BEAT with Subpart F. Generally the two regimes are applied separately.

For purposes of computing a domestic corporation's regular taxable income, the amounts included in income under Subpart F must be determined. This would include Subpart F income, global intangible low-taxed income (''GILTI''), and investments in U.S. property.[15]

There are no special rules for applying Subpart F differently to deductible payments received by a CFC from a related domestic corporation. This is the case even if such payments are added back to the domestic corporation's regular taxable income for purposes of calculating modified taxable income and, accordingly, the BEAT.

A group's regular taxable income is calculated by generally deducting 50% of the amount of any GILTI inclusion.[16] In addition, a 100% deduction generally is available for any dividends received from a CFC in calculating regular taxable income.[17]

The amounts included in regular taxable income under Subpart F are included in modified taxable income without adjustment. Like the computation of regular taxable income, only 50% of the GILTI inclusion is taken into account, and dividends received from CFCs that qualify for the 100% dividends received deduction are excluded from modified taxable income.[18]

For purposes of calculating modified taxable income, the amounts of relevant deductible payments made to related CFCs are added back to regular taxable income. As discussed above, such payments include interest, certain services fees (subject to the above discussion), royalties and rents (but do not include payments for goods). This is the case even if such payments are included in the taxpayer's income under Subpart F. In addition, if a domestic corporation acquires property from a related CFC, the amortization and depreciation deductions would be added to regular taxable income to arrive at modified taxable income.

To illustrate, assume a domestic corporation derives $2,200 of income from exploiting certain intangible property and incurs $200 of expense in the United States (and for the sake of the example, assume this is the only income and expense of the domestic corporation). The domestic corporation would have regular taxable income of $2,000 ($2,200 − $200), and $420 of U.S. tax liability ($2,000 × 21%).

[14] §59A(e)(1)(C).

[15] §951(a)(1)(A), §951(a)(1)(B), §951A.

[16] §250(a).

[17] §245A.

[18] These deductions are not taken into account for purposes of calculating the *de minimis* exception. *See* §59A(c)(4)(B)(i), §59A(e)(1)(C).

Alternatively, assume that a related CFC owns the relevant intangible property and incurs the $200 of expense, and that the domestic corporation pays a royalty to the CFC of $1,200. Assume that the royalty is not Subpart F income or GILTI.[19] The domestic corporation's regular taxable income would be $1,000 ($2,200 − $1,200) resulting in regular tax liability of $210. For BEAT purposes, modified taxable income would be $2,200 (adding back the $1,200 payment made to the CFC) and the minimum tax amount would be $220 ($2,200 × 10%), resulting in a BEAT of $10 ($220 − $210).

If instead the royalty were taxable as Subpart F income, the domestic corporation would have $1,000 of Subpart F income ($1,200 − $200), and regular taxable income of $2,000 ($2,200 + $1,000 − $1,200). Assume no foreign income taxes are paid by the CFC on the royalty income. Regular tax liability would be $420 ($2,000 × 21%). For BEAT purposes, the $1,200 deductible royalty payment would be added to regular taxable income, for modified taxable income of $3,200. Applying the 10% rate would yield $320 as a minimum tax amount, which would be less than $420 of regular tax liability. Thus, the BEAT would not apply, but the Subpart F income eliminates the benefit of the royalty deduction for purposes of calculating regular tax liability.[20]

Now assume that the royalty is subject to a 25% income tax in the foreign country. Assuming the royalty is Subpart F income and a foreign tax credit is claimed, the amounts of regular taxable income ($2,000) and modified taxable income ($3,200) would be the same as above.[21] The regular tax liability, however, would be $210, with U.S. tax on the $1,000 of Subpart F income being reduced to zero with foreign tax credits (assuming no expense are allocated to the inclusion). Under this scenario, the BEAT would be $110 ($320 − $210).[22] Foreign tax credits do not reduce the BEAT even though the §78 gross-up is in-

[19] For example, the income qualifies for the high tax exception and an election is made to exclude the royalty from Subpart F income (and, in such case, the royalty would also be excluded from GILTI). §954(b)(4); §951A(c)(2)(A)(i)(III).

[20] If instead the $1,000 were GILTI, assuming no reduction for a routine return, regular taxable income would be $1,500, and modified taxable income would be $2,700. The BEAT would not apply because regular tax liability of $315 ($1,500 × 21%) would exceed $270. The amount of GILTI may be less taking into account a reduction for routine returns on depreciable tangible property of the CFC.

[21] Subpart F income would be $750 ($1,200 − $200 − $250), and the gross-up under §78 would be $250, for a total inclusion of $1,000.

[22] The $210 of foreign tax credits used to reduce regular tax on the Subpart F income apparently are effectively lost, and only the $40 of excess credits can be carried over. If the CFC's income were not Subpart F income but instead GILTI, regular taxable income would be $1,500 ($2,200 − $500 − $1,200) and modified taxable income would be $2,700 ($1,500 − $1,200) (assuming no reduction of GILTI for routine returns) and the regular tax liability would be $210 (assuming full foreign tax credit utilization). The BEAT would be $60 ($270 − $210). All of the foreign tax

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

cluded in modified taxable income that is subject to the 10% minimum tax.[23]

In Sum . . .

U.S.-based multinationals will need to consider the implications of Subpart F when applying the BEAT rules. Ideally, the *de minimis* exception is met so the BEAT does not apply. Alternatively, a domestic corporation may have sufficient U.S. regular tax liability such that there is no BEAT minimum tax. If, however, the BEAT applies, deductible payments to a related CFC can result in substantial additional tax liability particularly when the income is subject to foreign taxation and included in income as Subpart F income (or GILTI).[24] What "base erosion" or "abuse" may be thought to exist in such a situation remains a mystery.

credits associated with the GILTI inclusion effectively would be lost.

[23] Consideration might be given to making an election to apply the high-tax exception, in which case modified taxable income would not include the $1,000 (Subpart F income and the gross-up), and the BEAT would be reduced to $10. Alternatively, under certain circumstances it may be desirable to forgo for a year a foreign tax credit for foreign income taxes and thereby not include the gross-up amount in income.

[24] Under certain circumstances, it may be desirable to conduct the foreign operations as a branch or disregarded entity of a U.S. corporation to avoid adding payments made to foreign entities in calculating modified taxable income (although other ramifications of a branch structure would need to be considered, including the imposition of current-basis U.S. tax on branch operations and the new separate foreign tax credit basket for branch operations).

PANEL OF CONTRIBUTORS

Thomas S. Bissell, CPA
Celebration, Florida

David Ernick
PricewaterhouseCoopers LLP
Washington, D.C.

Edward Tanenbaum, Esq.
Alston & Bird LLP
New York, New York

Robert E. Ward, Esq.
Kornfeld LLP
Vancouver, British Columbia

Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

Gary D. Sprague, Esq.
Baker & McKenzie LLP
Palo Alto, California

James J. Tobin, Esq.
Ernst & Young LLP
New York, New York

Lowell D. Yoder, Esq.
McDermott Will & Emery LLP
Chicago, Illinois

This section features brief commentary written on a rotating basis by leading international tax practitioners.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

LEGISLATION

Current Status of Legislation Relating to U.S. International Tax Rules

By Sean Hailey, CPA and Stephen Peng, Esq.
Ernst & Young LLP
International Tax Services
Washington, D.C.

Editor's Note: This column reports on significant bills introduced in the first session of the 115th Congress that would affect international provisions of the Internal Revenue Code. Bills are listed in chronological order, based on the date of introduction. Bills from the 115th Congress that have been enacted into law are listed at the end hereof, in order of date of enactment. New material is indicated in bold italics, and the column is current as of ***May 26, 2018***.

Bill No.: H.R. 685
Name: Bring Jobs Home Act
Sponsor: Pascrell (D-NJ) and 10 co-sponsors
Action: Introduced in the House of Representatives on January 24, 2017.

Provisions: The bill aims to encourage domestic insourcing, while discouraging foreign outsourcing. To accomplish it, the bill creates two new sections that would apply if a taxpayer itself or any member of the taxpayer's expanded affiliated group defined under §1504(a) but with a more than 50% stock ownership requirement, completes an insourcing or outsourcing of a business unit.

New §45S would provide a credit in an amount equal to 20% of certain eligible insourcing expenses generally consisting on expenses paid or incurred by the taxpayer (or any member of its expanded affiliated group) in connection with the elimination of a business unit located outside the United States, as well as expenses paid or incurred by the taxpayer to establish a business unit within the United States.

New §280I would deny deductions for specified outsourcing expenses consisting primarily in the elimination of any business unit of a taxpayer (or any member of its expanded affiliated group) in the United States and the establishment of a business unit outside the United States. The international tax provision of the bill would:

- Add a new paragraph to §952(c) to provide that earnings and profits of any controlled foreign corporation, for purposes of determining limitations on subpart F income, is to be determined without regard to specified outsourcing expenses as defined in new §280I.
- Would be effective for expenses paid or incurred after the date of the enactment.

★ ★ ★

Bill No.: S. 234
Name: End Outsourcing Act
Sponsor: Donnelly (D-IN) and 12 co-sponsors
Action: Introduced in the Senate on January 24, 2017.

Provisions: The bill aims to provide incentives to employers to keep jobs in the United States through adding several new sections to the Internal Revenue Code of 1986.

New §280I (see H.R. 685 above) would deny deductions for certain outsourcing expenses.

New §280J would deny certain deductions and accounting methods for outsourcing employers.

New §54BB would increase the tax liability of a taxpayer owning a facility where there has been an outsourcing of jobs to a country outside of the United States, by an amount equal to the recapture of credits and grants provided to the facility by the Secretary during the preceding 5 taxable years.

New §45S (see H.R. 685 above) would provide a credit in an amount equal to 20% of certain eligible insourcing expenses. The international tax provisions of the bill are identical to the international tax provisions included in H.R. 685 (see above), and would:

- Add a new paragraph to §952(c) to provide that earnings and profits of any controlled foreign corporation, for purposes of determining limitations on subpart F income, is to be determined without regard to specified outsourcing expenses as defined in new §280I.
- Would be effective for expenses paid or incurred after the date of the enactment.

★ ★ ★

Bill No.: S. 247
Name: Bring Jobs Home Act
Sponsor: Stabenow (D-MI) and 15 co-sponsors

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Action: Introduced in the Senate on January 30, 2017.

Provisions: The bill, including international tax provisions, are identical to the provisions included in H.R. 685 (see above), which was introduced in the House of Representative on January 24, 2017.

★ ★ ★

Bill No.: H.R. 1451

Name: Corporate Tax Dodging Prevention Act

Sponsor: Schakowsky (D-IL)

Action: Introduced in the House of Representatives on March 9, 2017.

Provisions: The bill aims to amend the Code to modify the treatment of foreign corporations. The international tax provisions of the bill would:

- Eliminate deferral of accumulated and current active income of controlled foreign corporations.
  - Include as subpart F income under §952 income derived from any foreign country by any controlled foreign corporation, taking into account deductions properly allocable to such income and treating income paid through one or more entities as derived from a foreign country if such income was, without regard to such entities, derived from such country.
  - Include as subpart F income under §965 the accumulated deferred foreign income of the CFC.
    - Define accumulated deferred foreign income as the undistributed earnings over the undistributed U.S. earnings of the controlled foreign corporation.
      - Define undistributed earnings as the earnings and profits of the controlled foreign corporation as described in §959(c)(3) determined as of the close of the taxable year and without diminution by reason of distributions made during taxable year.
      - Define undistributed U.S. earnings as the post-1986 undistributed U.S. earnings as defined in §245(a)(5).
  - Include an election for the U.S. shareholder of a controlled foreign corporation to pay the net tax liability in two or more, but fewer than eight equal installments.
  - Would be effective for taxable years beginning after December 31, 2017.

- Modify §901 as applicable to large integrated oil companies which are dual capacity taxpayers.
  - Exclude from being considered a foreign tax under §901 any amount paid or accrued to a foreign country or possession of the United States by a dual capacity taxpayer which is a large integrated oil company if,
    - The foreign country or possession does not impose a generally applicable income tax for the applicable period, or
    - To the extent such amount paid exceeds (1) the amount paid pursuant to the generally applicable income tax imposed by the country or possession, or (2) would be paid if the generally applicable income tax imposed by the country or possession were applicable to the dual capacity taxpayer.
  - Define generally applicable income tax as generally imposed under the laws of a foreign country or possession on income derived from the conduct of a trade or business in that country.
    - A tax will not be considered generally applicable unless it is substantially applicable to both persons who are not dual capacity taxpayers and persons who are citizens or residents of the foreign country or possession.
  - Define dual capacity taxpayer as a person who is subject to a levy in the foreign country or possession and receives (or will receive) directly or indirectly a specific economic benefit from the country or possession.
  - Define a large integrated oil company as an integrated oil company (within the meaning of §291(b)(4)) with gross receipts in excess of $1 billion for the taxable year and has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year.
  - Would be effective for taxable years beginning on or after the date of the enactment.

- Amend §904 to reinstate per-country foreign tax credit limitation.
  - Limit amount of credit for foreign taxes paid to a country or possession of the United States to an amount that is in the same proportion to such taxes paid as the amount of the taxpayer's taxable income from sources within the country or possession bears to the taxpayer's entire taxable income for the same taxable year.
  - Would be effective for taxable years beginning after December 31, 2017.

- Amend §7701 to treat as domestic corporations certain foreign corporations managed and controlled primarily within the United States.
  - Classify certain foreign corporations managed and controlled, directly or indirectly, primarily within the United States as domestic corporations.
    - Provide for regulations to determine what constitutes management and control primarily in the United States, but specify for those regulations to provide that management and control primarily occurs in the United States if substantially

Tax Management International Journal
© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

all the executive officers and senior management who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies are located primarily within the United States.

- Apply only to those foreign corporations whose stock is regularly traded on an established securities market or the aggregate gross assets of the corporation, including assets under management at any time during the taxable year or the preceding taxable year is at least $ 50 million.
  - Exclude such corporations if in the preceding taxable year, the corporation is not regularly traded on an established securities market and has, and is reasonably expect to continue to have, aggregate gross assets of less than $50 billion and the Treasury Secretary has granted a waiver.
- Would be effective for taxable years beginning on or after the date which is 2 years after the date of the enactment.

- Amend §163 to limit the deduction for interest expense of members of financial reporting groups that have a foreign parent and excess domestic indebtedness.
  - Set the limitation as the sum of the excess limitation carryforwards for the taxable year from any preceding taxable year and the greater of the taxpayer's allocable share of the applicable financial reporting group's net interest expense for the taxable year or 10% of the taxpayer's adjusted taxable income for the taxable year.
    - Allow any amount disallowed for a taxable year to be carried forward to the succeeding taxable year.
    - Allow any excess limitation for a taxable year to be carried forward to three succeeding taxable years.
    - Set the limitation to be at least the amount of interest income for the taxable year.
  - Define a taxpayer's allocable share of an applicable financial reporting group's net interest expense for any taxable year as the total net interest expense multiplied by a ratio, which is the net earnings of the taxpayer over the aggregate net earnings of all members of the applicable financial group.
  - Compute net earnings without regard for any reduction allowable for net interest expense, taxes, depreciation, amortization, or depletion, and with regard to adjustments prescribed by any regulations promulgated.
  - Determine both net interest expense and net earnings on the basis of the applicable financial statement of the applicable financial reporting group for the last financial reporting year ending with or within the taxable year and under U.S. federal income tax principles.
    - Define applicable financial reporting group as a group of which a corporation is a member and which files an applicable financial statements.
      - Exclude those financial reporting groups if the aggregate net interest expense for which a deduction is allowable to all members of the respective group is less than $5 million.
      - Exclude from an applicable financial reporting group certain financial institutions specifically defined as banks.
  - Would be effective for taxable years beginning after December 31, 2017.

- Amend §7874 to also treat a foreign corporation as a domestic corporation if the foreign corporation is an inverted domestic corporation.
  - Define an inverted domestic corporation as an otherwise foreign corporation that completes after May 8, 2014, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the assets of or substantially all of the properties constituting a trade or business of a domestic partnership, and after the acquisition more than 50% of the stock, by vote or by value, of the entity is held by former shareholders or partners of the domestic corporation or partnership, respectively, by reason of holding stock or an interest in the acquired domestic corporation or partnership.
    - Exclude from treatment as an inverted domestic corporation if after the acquisition the expanded affiliated group which includes the entity has substantial business activities in the foreign country in which or under the law of which the entity is created or organized.
  - Would be effective for taxable years beginning after May 8, 2014.

★ ★ ★

Bill No.: S. 586

Name: Corporate Tax Dodging Prevention Act

Sponsor: Sanders (D-VT) and Schatz (D-HI)

Action: Introduced in the Senate on March 9, 2017.

Provisions: The bill is identical to the provisions included in H.R. 1451 (see above), which was introduced in the House of Representative on March 9, 2017.

★ ★ ★

Bill No.: H.R. 1670

Name: Infrastructure 2.0 Act

Sponsor: Delaney (D-MD) and 20 co-sponsors

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

Action: Introduced in the House of Representatives on March 22, 2017.

Provisions: The bill is an international tax reform bill that includes provisions substantially similar to provisions included in H.R. 625, introduced by Delaney (D-MD) in the 114th Congress on January 30, 2015. The international tax provisions would:

- Amend §965 to treat deferred foreign income as subpart F income.
  - Provide that the subpart F income of a deferred foreign income corporation is increased by an amount equal to its accumulated post-1986 deferred foreign income in the last taxable year that ends before the date of enactment of the bill.
    - ''Deferred foreign income corporation'' would mean a controlled foreign corporation (''CFC'') or a §902 corporation (as defined in §909(d)(5)) that has accumulated post-1986 deferred foreign income.
      - Would treat a §902 corporation as a CFC solely for purposes of taking into account the subpart F income under this provision.
    - ''Accumulated post-1986 deferred foreign income'' would mean post-1986 earnings and profits (''E&P''), not including income of the deferred foreign income corporation effectively connected with a U.S. trade or business or previously taxed income under §959.
      - Would provide rules for allocating E&P deficits to offset post-1986 positive E&P.
  - Allow the U.S. shareholder of the deferred foreign income corporation a deduction in an amount equal to 75% of the amount included in income, reducing the effective tax rate on such inclusion to 8.75%.
  - Not allow a foreign tax credit or a deduction for foreign taxes paid with respect to the deductible portion of the inclusion, and not apply the §78 gross-up to any tax not allowable as a credit.
  - Allow the tax on the inclusion to be paid in eight annual installments without interest, subject to certain acceleration rules.
  - Provide that the inclusion of deferred income as subpart F income would not trigger any recapture of an overall foreign loss.

The other international tax provisions are included in the ''Fallback International Tax Reform'' section of the bill. Unless otherwise stated, these provisions would be effective 18 months after date of enactment. However, these provisions would not take effect if another bill that reforms the corporate international tax system ''to eliminate the incentive to hold earnings in low-tax foreign jurisdictions'' is enacted during the 18-month period that begins on date of enactment of this bill. These provisions would:

- Restructure subpart F rules
  - Replace the subpart F rules with two broad categories of subpart F income.
    - Up to 35% of the ''modified active income'' of a CFC would be includible in subpart F income, and taxed at the full U.S. corporate tax rate, offset by foreign tax credits (therefore, the excluded portion of the modified active income would be at least 65%); and
    - ''Modified nonactive income'' of a CFC would be taxed at the full U.S. corporate tax rate, offset by foreign tax credits.
  - Modify the foreign personal holding company income category, including substantial modifications to the active financing exception.
  - Modify the insurance income category.
  - Permit an exemption for capital gain on the sale of CFC stock to the extent the gain is attributable to the CFC's aggregate subpart F income during a look-back period.
  - Reduce a loss from the sale of CFC stock in an amount equal to the shareholder's cumulative exclusion from income of the CFC's modified active income.
  - Provide for tax-free repatriation from CFCs under previously taxed income rules.
    - For this purpose, the excludible portion of the CFC's modified active income would be treated as previously taxed income.
- Reform foreign tax credit limitation.
  - Disallow a credit or deduction for taxes paid or accrued with respect to the excludible portion of a CFC's modified active income.
  - Apply the foreign tax credit limitation separately to three income categories: (1) subpart F income from active foreign market income; (2) passive income; and (3) all other income.
  - Reinstate a per-country foreign tax credit limitation.
  - Provide transition rules to address the allocation of existing foreign tax credits to the new foreign tax credit limitation baskets.
- Disallow the deduction for expenses allocable to exempt income of a CFC.
  - Disallow the deduction for a portion of the interest expense of a corporate U.S. shareholder of a CFC that is apportioned to the excludible portion of the modified active income of a CFC.
  - Disallow the deduction for expenses of a corporate U.S. shareholder of a CFC that are directly allocable to the excludible portion of the modified active income of a CFC.
- Provide special treatment of pre-effective date deferred foreign income.
  - Provide for an immediate inclusion of a speci-

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

fied portion (not to exceed 35%) of the accumulated deferred foreign earnings of a deferred foreign income corporation at the full U.S. corporate tax rate.

- Provide for an immediate inclusion of a specified portion of the accumulated deferred foreign income of a CFC with a deduction that would result in an effective tax rate of 20% on such income.
    - The coordination between these two pre-effective date deferred foreign income provisions is not entirely clear from the statutory language.
- Provide other modifications to subpart F.
    - Eliminate the uninterrupted-30-day-period-or-more requirement under §951(a)(1) for treatment of a foreign corporation as a CFC.
    - Expand the definition of ''United States shareholder'' to include any U.S. person that owns 10% or more of the total value of shares of all classes of stock of a foreign corporation.
- Provide other modifications to foreign tax credit rules.
    - Repeal the indirect foreign tax credit (§902).
    - Modify §960 to limit the foreign tax credit to an amount that is properly attributable to the subpart F inclusion; the credit would apply based on current year subpart F inclusions and attributable taxes.
    - Allow a deemed-paid credit with respect to distributions of previously taxed income, subject to certain conditions.
    - Repeal the provisions relating to so-called ''splitter arrangements'' (§909).

Bill No.: H.R. 1673

Name: Water Affordability, Transparency, Equity, and Reliability Act of 2017

Sponsor: Conyers (D-MI) and 22 co-sponsors

Action: Introduced in the House of Representatives on March 22, 2017.

Provisions: The bill aims to establish a trust fund to provide funding for water and sewer infrastructure and other purposes. The international provision of the bill would:

- Eliminate deferral of all income of controlled foreign corporations by including as subpart F income under §952 income derived from any foreign country by any controlled foreign corporation.
    - Would be effective for taxable years beginning after the date of the enactment and to taxable years of U.S. shareholders with or within which the taxable years of foreign corporations end.

Bill No.: H.R. 1669

Name: Partnership to Build America Act of 2017

Sponsor: Delaney (D-MD) and 23 co-sponsors

Action: Introduced in the House of Representatives on March 22, 2017.

Provisions: The bill is substantially similar to three prior bills of the same name, H.R. 413, which was introduced in the 114th Congress on January 20, 2015, H.R. 2084 and S. 1957, which were introduced in the 113th Congress on May 22, 2013, and January 16, 2014, respectively. The bill also includes provisions that are substantially similar to provisions included in another prior bill, H.R. 4550, which was introduced in the 113th Congress on May 1, 2014.

The international tax provision of the bill would exclude from income of a U.S. corporate shareholder an amount of the cash dividends received during the year from controlled foreign corporations (''CFCs'') in an amount no greater than six times the amount of the U.S. shareholder's investment in the qualified infrastructure bonds that are provided for in another provision of the bill.

- The excluded amount is not to exceed the lesser of the amount of cash dividends for such year or the amount shown on the applicable financial statement as earnings permanently reinvested outside the United States.
- The excluded amount also is not to exceed the excess, if any, of the cash dividends received during the taxable year from CFCs, over the annual average cash dividends received from CFCs during three of the five most recent preceding taxable years, disregarding the taxable year with the largest amount of dividends and the taxable year with the smallest amount of dividends.
    - Rules for taxpayers having fewer than five preceding taxable years and for taxpayers that had certain merger and acquisition or spinoff transactions are provided.
- The amount of dividends received from a CFC would be reduced by any increase in indebtedness of the CFC to any related person (as defined in §954(d)(3)) measured at the close of the taxable year and at the close of the preceding taxable year.
- All CFCs of a U.S. shareholder would be treated as one CFC.
- Dividends would not include an amount includible in gross income as a dividend under §78, §367, or §1248, or the all earnings and profits inclusion amount under §367(b).
- No deduction would be allowed under §243 or §245 for any dividend that is excluded from income.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- All U.S. shareholders that are members of an affiliated group filing a consolidated return would be treated as one U.S. shareholder.
- No foreign tax credit or deduction would be allowed for foreign taxes paid or accrued (or deemed paid or accrued) with respect to the excluded portion of any dividend.
- No deduction would be allowed for expenses directly allocable to the excluded portion of any dividend.
- Would apply to dividends received in taxable years ending after date of enactment.

Bill No.: H.R. 1932 and S. 851
Name: Stop Tax Haven Abuse Act
Sponsor: In the House of Representatives, Doggett (D-TX) and 46 co-sponsors; in the Senate, Whitehouse (D-RI)
Action: Introduced in the House of Representatives and in the Senate on April 5, 2017.
Provisions: The bills are substantially similar to S. 1533, which was introduced in the 113th Congress on September 19, 2013. In addition, the bill includes provisions that are substantially similar to provisions included in S. 2360, which was introduced in the 113th Congress on May 20, 2014; and H.R. 297 and S. 174 which were introduced in the 114th Congress on January 13, 2015.

The international tax provisions of the bill would:

- Authorize Treasury to use Patriot Act authority to require U.S. financial institutions to take special measures against foreign jurisdictions or financial institutions found by Treasury to be ''impeding U.S. tax enforcement.'' The provision also would allow Treasury to prohibit a U.S. financial institution from opening correspondent accounts involving particular foreign banks or jurisdictions.
  - The bill does not specify an effective date for this provision.
- Modify and expand specific rules included in the Foreign Account Tax Compliance Act (''FATCA'') by:
  - Expanding the annual tax return obligation under §1298(f) for passive foreign investment companies;
  - Amending §1471 to explicitly cover transaction accounts and derivatives in the FATCA definitions;
  - Amending the §1472 rules by specifying when a withholding agent ''knows or has reason to know'' that an account is directly or indirectly owned by a U.S. person and by explicitly limiting the authority of the Treasury Secretary to waive the application of the FATCA requirements to entities identified as posing a low risk of tax evasion;
  - Amending §1473 to clarify that the definition of ''substantial United States owner'' includes U.S. persons who are beneficial owners;
  - Amending §1474 to provide exceptions to the confidentiality rules with respect to information disclosed to the IRS by foreign financial institutions under FATCA;
  - Amending §6038D, which imposes a tax return disclosure obligation on U.S. taxpayers with interests in ''specified foreign financial assets,'' to explicitly provide that the disclosure requirement applies to persons who have beneficial ownership interests in such assets; and
  - Establishing several rebuttable evidentiary presumptions that would presume a U.S. taxpayer's control of offshore entities the taxpayer forms or does business with, unless the taxpayer presents clear and convincing evidence to the contrary.
  - These FATCA-related provisions would apply as of the date that is 180 days after date of enactment.
- Generally treat a foreign corporation that either is publicly traded or has $50 million or more in aggregate gross assets at any time during the taxable year or any preceding taxable year as a U.S. corporation if the management and control of the corporation occurs, directly or indirectly, primarily in the United States.
  - Would apply to taxable years beginning on or after the date that is two years after date of enactment.
- Require withholding agents to report U.S. beneficial owners of, and U.S.-source income of, nonpublicly traded foreign entities if U.S. persons own interests in the entities or their accounts. Require any financial institution directly or indirectly opening a bank, brokerage, or other financial account for or on behalf of an offshore entity in a ''non-FATCA institution'' at the direction of, on behalf of, or for the benefit of a U.S. person to file an information return with respect to such account and such U.S. person.
  - Would apply with respect to amounts paid into foreign-owned accounts located in the United States after December 31 of the year of date of enactment or for accounts opened after December 31 of the year of date of enactment.
- Treat swap payments to nonresident alien individuals and foreign corporations as U.S.-source income taxable under §871 and §881. Section

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

871(a)(1) and §881(a) would be further amended to provide that the source of a swap payment is determined by reference to the location of the payor.
- The bill does not specify an effective date for this provision.

- Direct the SEC to issue rules to require a company issuing financial statements to include aggregated financial information from all subsidiaries on a country-by-country basis. Such financial information would include: (1) revenues from related and unrelated parties and in total; (2) profit or loss before taxes; (3) current income tax accrued; (4) cash basis income tax paid; (5) stated capital; (6) accumulated earnings; (7) number of employees; (8) tangible assets other than cash or cash equivalents; and (9) any other financial information necessary or appropriate in the public interest or for the protection of investors. Rules addressing grouping of foreign subsidiaries also are provided.
  - Would apply one year after the date on which the SEC issues final rules under this provision.

- Modify and expand the John Doe summons procedures, including, among other modifications, to allow courts to presume that there is a reasonable basis for believing tax compliance issues will arise in any John Doe summons proceeding involving a person or ascertainable group or class of persons with financial accounts in, or transactions related to, a non-FATCA institution.
  - Would apply to summonses issued after date of enactment.

- Defer deductions for expenses that are treated as related to foreign-source income not currently subject to U.S. income tax.
  - Would apply to taxable years beginning after date of enactment.

- Impose current U.S. tax on certain "excess returns" associated with intangibles transferred from the United States to a controlled foreign corporation ("CFC").
  - Would apply to taxable years beginning after date of enactment.

- "Clarify" the definition of "section 197 property" for purposes of §482 and §367(d), tighten the rules regarding the valuation of intangibles, and tighten the rules regarding intangible property transfers.
  - Would apply to transfers in taxable years beginning after date of enactment.

- Eliminate the check-the-box election for foreign entities by adding to the definition of "corporation" in §7701(a)(3) any foreign business entity that either: (1) has a single owner that does not have limited liability; or (2) has one or more members all of which have limited liability.
  - Would apply on date of enactment.

- Eliminate the §954(c)(6) "look-thru rule," effective for dividends, interest, rents, and royalties from related CFCs.
  - Would apply to payments received or accrued after date of enactment.

- Add a new subsection under §163 which would defer deductions for "excessive interest" of U.S. members of a financial reporting group with excess domestic indebtedness.
  - Would apply to taxable years beginning after date of enactment.

- Treat a foreign corporation as a U.S. corporation if the corporation would be a surrogate foreign corporation if §7874(a)(2) were applied by substituting "80 percent" for "60 percent" or the corporation is an "inverted domestic corporation."
  - Would apply to taxable years ending after May 8, 2014, with a sunset rule that would exclude acquisitions completed after January 4, 2017.

Bill No.: H.R. 1931
Name: Corporate EXIT Fairness Act
Sponsor: Doggett (D-TX) and 56 co-sponsors
Action: Introduced in the House of Representatives on April 5, 2017.

Provisions: The bill includes provisions that are substantially similar to provisions included in H.R. 5125, which was introduced in the 114th Congress on April 29, 2016. The bill aims to discourage corporate inversions and impose tax on unrepatriated earnings and unrecognized gains in connection with corporate expatriations. The international tax provisions would:

- Insert a §7874A named "Rules relating to corporate inversions and corporate expatriations"; this new section would:
  - With respect to "corporate expatriations": (1) characterize as subpart F income any accumulated deferred foreign income of any applicable controlled foreign corporation for its last taxable year ending before the acquisition date; and (2) treat as sold for its fair market value any "gain position stock" of any controlled foreign corporation held by an expatriated entity on the acquisition date.

  A disposition of gain position stock by any applicable controlled foreign corporation by an expatriated entity at any time during the five-year pe-

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

riod ending on the acquisition date would also be treated as a sale of such stock for its fair market value and the period of limitation on assessment and collection of any tax with respect to such disposition under §6501 or §6502 would commence not earlier than the acquisition date.

- Define "gain position stock" as any stock if gain would arise from the sale of such stock.
- Allow for proper adjustment in the amount of any gain or loss subsequently realized.

- Treat as a U.S. corporation any foreign corporation making the acquisition in the case of a "corporate inversion."
  - Allow for an agreement to be entered into by the common parent of the expanded affiliated group that includes the foreign corporation making the acquisition in a corporate expatriation with the Secretary that would treat the foreign corporation as domestic and would exempt the foreign corporation from characterizing its accumulated deferred foreign income as subpart F income and treating any gain position stock as sold for its fair market value (with due assurances that the foreign corporation's treatment as domestic will be administrable and enforceable).
  - Define "corporate inversion" as a direct or indirect acquisition of: (1) substantially all of the assets of a U.S. corporation or partnership; (2) substantially all of the trade or business assets of a U.S. corporation or partnership; or (3) substantially all of the U.S. trade or business assets of a foreign partnership, by a foreign corporation where
    - such acquisition is completed after January 4, 2017,
    - after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign corporation is created or organized, when compared to the total business activities of such expanded affiliated group, and
    - after the acquisition, either: (1) more than 50% of the stock (by vote or value) of the foreign corporation is held by, in the case of an acquisition with respect to a U.S. corporation, former shareholders of the U.S. corporation and, in the case of an acquisition with respect to a partnership, by former partners; or (2) the management and control of the expanded affiliated group that includes the foreign corporation occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has "significant domestic business activities."
      - Stock held by members of the expanded affiliated group that includes the foreign corporation or stock of the foreign corporation that is sold in a public offering related to the acquisition would be disregarded for this determination.
      - The management and control of an expanded affiliated group would be treated as occurring, directly or indirectly, primarily within the United States if substantially all of the executive officers and senior management of the expanded affiliated group who, regardless of their title, exercise daily responsibility for making strategic, financial, and operational decisions of the expanded affiliated group are primarily located within the United States.
      - "Significant domestic business activities" would be defined as at least 25% of the employees, employee compensation, assets, or income being based or located or derived in the United States.
  - Define "corporate expatriation" as a direct or indirect acquisition of: (1) substantially all of the assets of a U.S. corporation or partnership; (2) substantially all of the trade or business assets of a U.S. corporation or partnership; or (3) substantially all of the U.S. trade or business assets of a foreign partnership, by a foreign corporation completed before January 4, 2017.
    - Deem as pursuant to a plan for corporate inversion and corporate expatriation respectively in case of an acquisition completed: (1) during the four-year period beginning on the date that is two years before the 50% ownership requirement is met; or (2) during the four-year period ending on the acquisition date.
    - Allow foreign tax credits only to the extent that the tax exceeds the product of the amount that is included in income and the highest rate of tax.
  - Would apply to taxable years ending after January 4, 2017.

- Rename §7874 to "Rules relating to corporate inversion completed on or before January 4, 2017"; this section would be modified and would:
- For corporate inversions completed on or before January 4, 2017, treat a foreign corporation as a U.S. corporation if: (1) such corporation would be a foreign corporation if the corporation would be a surrogate foreign corporation if §7874(a)(2) were applied by substituting "80 percent" for "60 percent," or if such corporation is an "inverted domestic corporation."
  - Define an "inverted domestic corporation" as an entity if:
    - pursuant to a plan, the entity completes, after May 8, 2014, and on or before January 4, 2017, the direct or indirect acquisition of: (1) substantially all of the assets of a U.S. corporation or partnership; (2)

Tax Management International Journal
© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

substantially all of the trade or business assets of a U.S. corporation or partnership; or (3) substantially all of the U.S. trade or business assets of a foreign partnership; and

- after all the acquisitions: (1) more than 50% of the stock (by vote or value) of the foreign corporation is held by the former shareholders or partners; or (2) the management and control of the expanded affiliated group that includes the foreign corporation occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has significant domestic business activities.
- ''Significant domestic business activities'' would be defined as at least 25% of the employees, employee compensation, assets, or income being based or located or derived in the United States.
- Except from the definition of ''inverted domestic corporation'' an entity if after the acquisition the expanded affiliated group that includes the entity has substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of the expanded affiliated group.
- Would apply to taxable years ending after May 8, 2014.

Bill No.: H.R. 2057
Name: Tax Fairness and Transparency Act
Sponsor: Pocan (D-WI) and 7 co-sponsors
Action: Introduced in the House of Representatives on April 6, 2017.
Provisions: The bill includes provisions that are substantially similar to provisions included in H.R. 3934, which was introduced in the 114th Congress on November 5, 2015. The bill aims to limit the interest deduction for excessive interest of members of financial reporting groups and to terminate the deferral of active income of controlled foreign corporations, and to require the disclosure of total corporate tax paid by a corporation in each annual report. The international tax provisions would:

- Add a new subsection under §163 which would defer deductions for interest expense to the extent the expense exceeds the sum of: (1) the amount of interest income includible in the corporation's gross income for the taxable year; plus (2) the corporation's proportionate share of the financial reporting group's net interest expense for the taxable year, computed under U.S. income tax principles.
  - If a corporation failed to substantiate its proportionate share of the financial reporting group's net interest expense for a taxable year (or it so elected), a corporation would defer deductions for interest expense that exceeded 10% of the corporation's adjusted taxable income.
- The new subsection would generally apply to a corporation for a taxable year if the corporation was a member of a financial reporting group, which would mean a group that prepares consolidated financial statements under U.S. GAAP, international financial reporting standards, or another method designated by the Secretary of the Treasury.
- The new subsection would not apply to a corporation that is predominantly engaged in the active conduct of a banking, financing, or similar business or to a corporation that has less than $5,000,000 of net interest expense for the taxable year.
- Any disallowed interest would be permitted to be carried forward for one taxable year.
- Any excess limitation would be permitted to be carried forward for three taxable years.
- Define subpart F income to include, in the case of any controlled foreign corporation, the income of such corporation derived from any foreign country.
- Would apply to taxable years beginning after December 31, 2017.

Bill No.: S. 863
Name: Offshoring Prevention Act
Sponsor: Whitehouse (D-RI)
Action: Introduced in the Senate on April 6, 2017.
Provisions: The bill includes provisions that are substantially similar to provisions included in H.R. 305 and S. 162, which were introduced in the 114th Congress on January 13, 2015. The international tax provisions of the bill would:

- Introduce a new category of Subpart F income under §954(a) for ''imported property income.''
  - ''Imported property income'' generally would be income of a controlled foreign corporation (''CFC'') derived in connection with the manufacturing, producing, growing, extracting, sale, exchange, other disposition, lease, rental, or licensing of imported property.
    - Would provide an exception for foreign oil and gas extraction income and foreign oil related income.
  - ''Imported property'' generally would be property imported into the United States by a

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

CFC or a related person, or property imported into the United States by an unrelated person if the property is sold to the unrelated person by the CFC (or a related person) and at the time of the sale it was reasonable to expect that the property would be imported into the United States or as a component in other property that would be imported into the United States.

- Would provide an exception for property imported into the United States that before substantial use in the United States is sold, leased, or rented by a CFC or a related person for direct use, consumption, or disposition outside the United States or is used by the CFC or a related person as a component in other property that is so sold, leased, or rented.
- Would provide an exception for any agricultural commodity not grown in commercially marketable quantities in the United States.
- ''Import'' would be defined as entering, or withdrawal from warehouse, for consumption or use, including any grant of the right to use intangible property in the United States.

- Add a new separate foreign tax credit limitation ''basket'' under §904(d)(1) for ''imported property income.''
- Would apply to taxable years of foreign corporations beginning after date of enactment, and to taxable years of United States shareholders with or within which the taxable years of foreign corporations end.

★ ★ ★

Bill No.: H.R. 2078

Name: Jump Start America Act of 2017

Sponsor: Williams (R-TX)

Action: Introduced in the House of Representative on April 6, 2017.

Provisions: The bill aims to amend several provisions of the Internal Revenue Code. The international tax provisions of the bill would:

- Provide a single corporate income tax rate of 20%.
- Make permanent an election to apply the §965 dividends received deduction to any taxable year.
- Amend the §965 dividends received deduction to apply to cash dividends received by a U.S. corporate shareholder from its controlled foreign corporations (''CFCs'') to the extent of the sum of the current and accumulated §959(c)(3) untaxed earnings of those CFCs.
- Amend the §965 dividends received deduction rate to 85.7% of the cash dividends received.
- Apply to taxable years ending after the date of the enactment.

★ ★ ★

Bill No.: H.R. 2136

Name: To amend the Internal Revenue Code of 1986 to provide an exception from certain reporting requirements with respect to the foreign accounts of individuals who live abroad.

Sponsor: Maloney (D-NY)

Action: Introduced in the House of Representative on April 25, 2017.

Provisions: The bill aims to provide an exception from certain reporting requirements with respect to the foreign accounts of individuals who live abroad. The international tax provisions of the bill would:

- Under §1471(d)(1), exclude from the definition of ''United States Account'' a depository account maintained by a foreign financial institution (''FFI'') if each holder of the account is an individual who would be a §911(d) bona fide resident of a foreign country in which such FFI is licensed to conduct business (unless the FFI elects not to exclude such account).
  - Authorize the Secretary to amend any agreements with such FFI to take into account such exclusion.
  - Take effect on the date of the enactment.
- Except from §6038D reporting depository and custodial accounts held by an individual with a financial institution to the extent the individual would be a §911(d) bona fide resident of a foreign country in which a financial institution is licensed to conduct business.
  - Apply to taxable years beginning after the date of the enactment.

★ ★ ★

Bill No.: H.R. 3217

Name: Stop Outsourcing and Create American Jobs Act of 2017

Sponsor: McNerney (D-CA)

Action: Introduced in the House of Representative on July 13, 2017.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to provide for the identification of corporate tax haven countries and increased penalties for tax evasion practices in tax haven countries. The international tax provisions of the bill would:

- Require the Secretary of the Treasury to develop and publish a list of countries determined to be

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

corporate tax haven countries within one year of enactment.

- Increase the accuracy-related penalty under §6662(a) to 60% for any portion of an underpayment by a corporation, which involves an undisclosed foreign financial asset located in a tax haven country.
- Increase the accuracy-related penalty for reportable transactions under §6662A to 40% for any portion of a reportable transaction understatement, which involves a transaction that originates, terminates, or otherwise occurs in a tax haven country.
- Increase the fraud penalty under §6663 to 100% for any fraud by a corporation involving an activity occurring in a tax haven country.
- Increase the erroneous claim for credit or refund penalty under §6676 to 40% for any excessive amount due for credit or refund claims involving funds held or invested in a tax haven country.
- Increase the fine under §7201 from $500,000 to $1,000,000 for willful attempt to evade or defeat any tax in case of an attempt by a corporation that involves a tax haven country.
- Increase the fine under §7207 from $50,000 to $150,000 for delivery or disclosure of fraudulent or false returns, statements, or other documents by a corporation which involves a tax haven country.
- Apply, respectively, to underpayments, returns, refunds and credits attributable to transactions, and offenses committed after the date on which the tax haven list is first published.

Bill No.: H.R. 3434 and S. 1636

Name: Stop Corporate Inversions Act of 2017

Sponsor: In the House of Representatives, Levin (D-MI) and 4 co-sponsors; in the Senate, Durbin (D-IL) and 10 co-sponsors

Action: Introduced in the House of Representatives and in the Senate on July 26, 2017.

Provisions: The bill is substantially similar to provisions included in H.R. 1451, which was introduced on March 9, 2017, and provisions included in H.R. 1932 and S. 837, which were introduced on April 5, 2017. The international tax provisions of the bill would:

- Treat a foreign corporation as a U.S. corporation if: (1) such corporation would be a foreign corporation if the corporation would be a surrogate foreign corporation if §7874(a)(2) were applied by substituting ''80 percent'' for ''60 percent,'' or if such corporation is an ''inverted domestic corporation.''
- Define an ''inverted domestic corporation'' as an entity if:
  - pursuant to a plan, the entity completes, after May 8, 2014, and on or before January 4, 2017, the direct or indirect acquisition of: (1) substantially all of the assets of a U.S. corporation or partnership; (2) substantially all of the trade or business assets of a U.S. corporation or partnership; or (3) substantially all of the U.S. trade or business assets of a foreign partnership; and
  - after all the acquisitions: (1) more than 50% of the stock (by vote or value) of the foreign corporation is held by the former shareholders or partners; or (2) the management and control of the expanded affiliated group that includes the foreign corporation occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has significant domestic business activities.
    - ''Significant domestic business activities'' would be defined as at least 25% of the employees, employee compensation, assets, or income being based or located or derived in the United States.
- Except from the definition of ''inverted domestic corporation'' an entity if after the acquisition the expanded affiliated group that includes the entity has substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of the expanded affiliated group.
- Would apply to taxable years ending after May 8, 2014.

Bill No.: H.R. 3603

Name: Stop Corporate Earnings Stripping Act of 2017

Sponsor: Levin (D-MI) and 1 co-sponsor

Action: Introduced in the House of Representatives on July 28, 2017.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to prevent earnings stripping of corporations which are related to inverted corporations. The international tax provisions of the bill would:

- Introduce new §7874(g) to apply §163(j) as modified to any corporation (''related corporation'')

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

that for any taxable year, if at any time during such taxable year, is a member of an expanded affiliated group which includes an entity that is a surrogate foreign corporation.
• Surrogate foreign corporation for these purposes is defined under §7874(a)(2) by substituting ''more than 50 percent'' for ''at least 60 percent'' in §7874(a)(2)(B)(ii) and without regard to the substantial foreign country business activities exception under §7874(a)(2)(B)(iii).

- Applies §163(j) to such related corporation without regard to the 1.5-to-1 debt-to-equity ratio threshold under §163(j)(2)(A) and by modifying the definition of ''excess interest expense'' for the taxable year under §163(j)(2)(B) as the corporation's interest expense over 25 percent of the adjusted taxable income of the corporation for such year.
- Impose a 5-year limitation on the carryforward of interest expense disallowed for the taxable year by the provision. • Would apply to taxable years beginning after the date of enactment.

Bill No.: S. 1673
Name: Pay What You Owe Before You Go Act
Sponsor: Brown (D-OH) and 2 co-sponsors
Action: Introduced in the Senate on July 31, 2017.
Provisions: The bill aims to amend provisions of the Internal Revenue Code to include in income the unpretatriated earnings of groups that include an inverted corporation. The international tax provisions of the bill would:

- Introduce new §7874(g) to increase the subpart F income of any ''applicable controlled foreign corporation'' for its last taxable year ending before the ''acquisition date'' by the ''accumulated deferred foreign income'' of the corporation.
• Applicable CFC means any CFC with respect to which a ''covered entity'' was a United States shareholder at any time during the 5-year period ending on the acquisition date, or a member of the same expanded affiliated group as a ''covered entity'' was a United States shareholder at any time during the 5-year period ending on the acquisition date.
• Covered entity is a surrogate foreign corporation as defined under §7874(a)(2)(B) as modified to include any:
• foreign corporation that completes after July 24, 2017, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership);
• after the acquisition at least 50 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation (or former partners of a domestic partnership); and
• without regard to the substantial foreign country business activities exception under §7874(a)(2)(B)(iii).
- Acquisition date is the date after July 24, 2017, the covered entity completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership).
- Accumulated deferred foreign income of the applicable CFC is the excess of the undistributed earnings of the CFC over the undistributed U.S. earnings of such CFC.
- Would apply with respect to taxable years ending after July 24, 2017.

Bill No.: H.R. 3925
Name: Patriot Employer Act of 2017
Sponsor: Schakowsky (D-IL) and 2 co-sponsors
Action: Introduced in the House of Representatives on October 3, 2017.
Provisions: The bill aims to amend provisions of the Internal Revenue Code to provide a tax credit to Patriot employers, and for other purposes. The international tax provisions of the bill would:

- Introduce new §45S tax credit, Patriot employer tax credit, equal to 10% of qualified wages paid or incurred by a Patriot employer for the taxable year.
• Limits qualified wages to be taken into account with respect to any employee for any taxable year to $15,000.
• Defines a ''Patriot employer'' with respect to any taxable year as any taxpayer which, inter alia, satisfies the following requirements:
• maintains its headquarters in the United States if the taxpayer (or any predecessor) has ever been headquartered in the United States, and is not (and no predecessor of which is) an expatriated entity (as defined in §7874(a)(2)) for the taxable year or any preceding taxable year ending after March 4, 2003;
• which provides all employees with paid sick

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

leave or paid family and medical leave; and

• in the case of a taxpayer which employs an average of more than 50 employees on business days during the taxable year provides compensation for at least 90% of its employees at an hourly rate (or equivalent thereof) not less than an amount equal to 218% of the Federal poverty level.

• Would apply to taxable years beginning after December 31, 2017.

- Introduce new §163(n) to defer deduction for interest expense related to deferred income.

• Limits taxpayer's foreign-related interest expense allowed as a deduction for any taxable year as equal to the applicable percentage of the sum of taxpayer's (1) foreign-related interest expense for the taxable year, plus (2) deferred foreign-related interest expense.

• The ''applicable percentage'' is the percentage equal to the current inclusion ratio.

• ''Current inclusion ratio'', with respect to any domestic corporation which meets the ownership requirements of §902(a) and (b) with respect to one or more §902 corporations for any taxable year, is the ratio (expressed in percentage) of the sum of (1) all dividends received from such section 902 corporations, plus (2) all inclusions in gross income under §951(a) from such §902 corporations (without regard to §78), divided by the taxpayer's pro rata share of such §902 corporations' post-1986 undistributed earnings.

• ''Foreign-related interest expense'' is the amount which bears the same ratio to the amount of interest expense allocated and apportioned under §861, §864(e), and §865(f) to foreign-source income as value of all stock held by taxpayer in all §902 corporations with respect to which the taxpayer satisfies the ownership requirements of §902(a) and (b) bears to value of all assets of the taxpayer which generate foreign-source income.

• ''Deferred foreign-related interest expense'' is the excess, if any, of the aggregate foreign-related interest expense for all prior taxable years beginning after December 31, 2017, over the aggregate amount allowed as a deduction.

• Deferred foreign-related interest expense is allowed as a deduction in a subsequent taxable year to the extent that the limitation exceeds the taxpayer's foreign related-interest expense for such taxable year.

• Would apply to taxable years beginning after December 31, 2017.

★ ★ ★

Bill No.: H.R. 4045

Name: Removing Onerous Obstacles in the Tax code for Mainstreet Businesses Act

Sponsor: Barr (R-KY) and 1 co-sponsors

Action: Introduced in the House of Representatives on October 12, 2017.

Provisions: The bill aims to amend provisions of the Internal Revenue Code related to shareholder ownership and passive income rules of the personal holding company tax provisions. The international tax provisions of the bill would:

- Exclude from the definition of personal holding company under new §542(c)(9) a corporation with greater than 50% stock ownership (as defined in §542(a)) held by nonresident alien individuals with no effectively connected income under §871 or §877.
- Would apply to taxable years ending on or after the date of enactment of the Act.

★ ★ ★

Bill No.: H.R. 4060

Name: Tax Equity and Prosperity for Puerto Rican Families Act of 2017

Sponsor: Pascrell (D-NJ) and 12 co-sponsors

Action: Introduced in the House of Representatives on October 12, 2017.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to make residents of Puerto Rico eligible for the earned income tax credit and to provide for equitable treatment for residents of Puerto Rico with respect to the refundable portion of the child tax credit. The international tax provisions of the bill would:

- Introduce new §32(n) so as to make residents of Puerto Rico eligible for the earned income tax credit;
- Amend §24(d)(1) to take into account as earned income for purposes of the child tax credit any amount of income from sources within Puerto Rico derived by a bona fide resident of Puerto Rico that is excluded from gross income under §933.
- Would apply to taxable years beginning after December 31, 2016.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

Bill No.: H.R. 1

Name: Tax Cuts and Jobs Act

Sponsor: Brady (R-TX)

Action: Introduced in the House of Representatives on November 2, 2017.

Provisions: The bill aims to amend provisions of the Internal Revenue Code. The international tax provisions of the bill would:

- Reduce corporate income tax rate to 20%.
- Introduce new §245A to provide a deduction for the ''foreign-source portion'' of a dividend received from a ''specified 10%-owned foreign corporation'' by a domestic corporation which is U.S. shareholder with respect to such foreign corporation.
  - A ''specified 10%-owned foreign corporation'' means any foreign corporation with respect to which any domestic corporation is a U.S. shareholder. A specified 10% owned foreign corporation does not include a PFIC that is not a CFC.
  - The ''foreign-source portion'' of a dividend is an amount which bears the same ratio to the dividend as the post-1986 undistributed foreign earnings of the specified 10%-owned foreign corporation bears to the corporation's total post-1986 undistributed earnings.
  - The ''post-1986 undistributed earnings'' is the amount of earnings and profits (E&P) of the specified 10%-owned foreign corporation accumulated in tax years beginning after December 31, 1986, determined as of the close of the tax year of the specified 10%-owned foreign corporation in which the dividend is distributed and without diminution by reason of dividends distributed during such tax year.
  - The ''post-1986 undistributed foreign earnings'' is the portion of post-1986 undistributed earnings that is attributable to neither income effectively connected with the conduct of a U.S. trade or business, nor dividends received (directly or through a wholly-owned foreign corporation) from a domestic corporation at least 80% of the stock of which (by vote and value) is owned (directly or through such wholly owned foreign corporation) by the specified 10%-owned foreign corporation.
  - Credits and deductions for foreign taxes (including withholding taxes) paid or accrued with respect to any dividend benefiting from new §245A would be disallowed.
  - New §245A would apply to the distributions made after December 31, 2017.
- Repeal §956 with respect to U.S. shareholders that are domestic corporations effective for taxable years of foreign corporations beginning after December 31, 2017.
- Amend §965 to impose a transition tax by increasing the subpart F income of a ''deferred foreign income corporation'' in the last taxable year before January 1, 2018 by the greater of the ''accumulated post-1986 deferred foreign income'' as of November 2, 2017 or as of December 31, 2017.
  - A ''deferred foreign income corporation'' with respect to any U.S. shareholder is any ''specified foreign corporation'' (SFC) which has ''accumulated post-1986 deferred foreign income.''
  - A ''specified foreign corporation'' is any CFC and any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder (determined without regard to §958(b)(4)).
  - ''Accumulated post-1986 deferred foreign income'' is the ''post-1986 E&P'' other than income effectively connected with the conduct of a trade or business within the U.S. or that would be excluded from the gross income of a U.S. shareholder under §959 if distributed.
  - ''Post-1986 E&P'' is the E&P of the foreign corporation determined as of November 2, 2017 or as of December 31, 2017, whichever is applicable, without diminution by reason of dividends distributed during the taxable year ending on the applicable date, and increased by certain qualified deficits.
  - Cash and cash equivalents would be taxed at 14% and the remainder would be taxed at 7% with the option to pay the tax in eight equal installments.
- Repeal §902 deemed paid foreign tax credit and §955 inclusion of withdrawal of previously excluded subpart F income from qualified investment, both effective December 31, 2017.
- Amend §954(a) and §954(g) to repeal treatment of foreign base company oil-related income as subpart F income effective for taxable years of foreign corporations beginning after December 31, 2017.
- Amend §954(b)(3) to include an inflation adjustment for the de minimis exception effective for taxable years of foreign corporations beginning after December 31, 2017.
- Amend §958(b) to remove the restriction under §958(b)(4) on attribution of stock owned directly or indirectly by a foreign partner, beneficiary, or shareholder to a U.S. partnership, trust, estate, or corporation as provided by §318(a)(3); effective for taxable years of foreign corporations beginning after December 31, 2017.
- Amend §951(a)(1) to remove the requirement that a CFC must be a CFC for a 30-day period effec-

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

tive for taxable years of foreign corporations beginning after December 31, 2017.

- Amend §954(c)(6) to make the look-thru rule for CFCs permanent effective for taxable years of foreign corporations beginning after December 31, 2019.

- Introduce new §951A to require U.S. shareholder to include in gross income 50% of such shareholder's ''foreign high return amount.''
  - ''Foreign high return amount'' is the excess the excess, if any, of the U.S. shareholder's ''net CFC tested income'' for that taxable year over the excess (if any) of: (1) the U.S. shareholder's ''applicable percentage'' of its aggregate pro rata share of the ''qualified business asset investment'' of each CFC with respect to which it is a U.S. shareholder in that tax year, over (2) any interest expense taken into account in determining the U.S. shareholder's net CFC tested income for that tax year.

- A U.S. shareholder's ''net CFC tested income'' is the excess, if any, of its aggregate pro rata share of any ''tested income'' of each CFC, over its aggregate pro rata share of any ''tested loss'' of each CFC.
- A CFC's ''tested income'' is the excess, if any, of: (1) its gross income (other than ECI, subpart F gross income, amounts excluded from foreign personal holding company income under §954(c)(6) that do not reduce a U.S. shareholder's foreign high return amount, active insurance and financing income (under §954(h) and (i)), amounts excluded from foreign base company income under §954(b)(4), commodities income (as defined), and related-party dividends (as defined in §954(d)(3))) over (2) deductions (including taxes) properly allocable to such gross income under rules similar to those of §954(b)(5).
- ''Tested loss'' is the excess of: (1) properly allocated and apportioned deductions; over (2) gross income taken into account in determining tested income.
- The ''applicable percentage'' for any tax year would equal the federal short-term rate (determined under §1274(d)) for the month in which or with which such tax year ends, plus seven percentage points.
- A CFC's ''qualified business asset investment'' is the aggregate of its adjusted bases in tangible property used in the production of tested income or loss (''specified tangible property'') that is: (1) used in a trade or business of the CFC, and (2) of a type with respect to which a deduction is allowed under §168.

- Amend §960 to deem a domestic corporation that includes an amount in gross income under §951A to have paid foreign income taxes equal to 80% of ''foreign high return percentage,'' multiplied by the aggregate foreign income taxes paid or accrued by its CFC that are properly attributable to gross income taken into account in determining tested income or tested loss (defined as ''tested foreign income taxes'').
  - ''Foreign high return percentage'' would be the ratio of the domestic corporation's foreign high return amount to its aggregate tested income.

- Amend §904 to add a new separate limitation category for ''foreign high return amount'' and deny carryover of excess foreign taxes paid or accrued with respect to such separate limitation category.

- Amend §78 to compute the §78 gross-up for the amount of §960 deemed paid credit for taxes paid or accrued with respect to foreign high return amount as 100% of the amount of such foreign income taxes paid or accrued by the CFC.

- New §951A and the amendments to §960, §904, and §78 effective for taxable years of foreign corporations after December 31, 2017.

- Amend §163(j) to limit the deduction for business interest paid or accrued for the taxable year to the sum of (1) business interest income, (2) 30% of the ''adjusted taxable income,'' and floor plan financing interest.
  - Business interest income means any interest paid or accrued on indebtedness properly allocable to a trade or business (does not include investment interest as defined by §163(d)), but excludes trade or business of performing services as an employee, real property trade or business (as defined in §469(c)(7)(C)), and trade or business conducted by certain regulated public utilities.

- Floor plan financing interest is interest paid or accrued on indebtedness to finance acquisition of motor vehicles for sale to retail customers.
- Adjusted taxable income is taxable income computed without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business, (2) any business interest or business interest income, (3) amount of any NOL deduction under §172, and (4) any deduction allowable for depreciation, amortization, or depletion.
- Provides for partnership rule that applies the limitation at the partnership level and any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership.
- Amount of interest expense deduction disallowed by the limitation for the taxable year may be carried forward for subsequent five years on a first-in, first-out basis.
- Effective for taxable years beginning after December 31, 2017.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- Introduce new §163(n) to limit the deduction for interest paid or accrued by a domestic corporation that is a member of an international financial reporting group (''IFRG'') to the sum of (1) the ''allowable percentage'' of 110% of the excess (if any) of the net interest expense, and (2) interest income for the taxable year.
  - An IFRG is, with respect to any reporting year, any group of entities which (1) includes (i) at least one foreign corporation engaged in a U.S. trade or business, or (ii) at least one domestic corporation and one foreign corporation, (2) prepares consolidated financial statements with respect to such year, and (3) reports in such statements average annual gross receipts for the three-reporting-year period ending with such reporting year in excess of $100 million.
- The allowable percentage is the ratio (expressed in percentage and not greater than 100%) of the domestic corporation's ''allocable share'' of the IFRG's reported net interest expense, over the domestic corporation's reported net interest expense.
- Domestic corporation's allocable share of IFRG's reported net interest expense for any reporting year is computed as the domestic corporation's EBITDA as a percentage of the IFRG's EBITDA multiplied by the IFRG's reported net interest expense.
- IFRG's reported net interest expense is the aggregate interest expense over aggregate interest income reported in the IFRG's consolidated financial statements. Domestic corporation's reported net interest expense is interest expense over interest income reported in the books and records of the IFRG which are used in preparing the IFRG's consolidated financial statements.
- IFRG's EBITDA is the amount as determined in the IFRG's consolidated financial statements, and the domestic corporation's EBITDA is the amount as determined in the books and records of the IFRG which are used in preparing the IFRG's consolidated financial statements.
- Consolidated financial statement is generally a financial statement which is certified as being prepared in accordance with GAAP, IFRS, or any comparable method identified by Treasury/IRS, which is a 10-K, or an annual statement to shareholders, required to be filed with the U.S. SEC.
- Members of any group that file a consolidated return shall be treated as a single corporation for purposes of the limitation.
- Provide under new §163(o) that the lower of the limitation under §163(j) or §163(n) to apply, with amount of interest deduction disallowed for the taxable year by either provision to be carried forward for five years on a first-in, first-out basis.
- Effective for taxable years beginning after December 31, 2017.

- Introduce new §4491 to impose 20% excise tax on any ''specified amount'' paid by a domestic corporation that is a member of an international financial reporting group (IFRG) to a foreign corporation which is a member of the same IFRG, subject to the exception for such specified amounts paid to a foreign corporation that irrevocably elects to treat the amounts as income effectively connected to the conduct of a U.S. trade or business under new §882(g).
  - ''Specified amount'' is, with respect to the domestic corporation payor, any amount allowable as a deduction or includable in cost of goods sold, inventory, or basis of a depreciable or amortizable asset, but does not include interest, any amount paid to acquire a security or commodity, or any amount to which tax is imposed under §881(a).
- ''International Financial Reporting Group'' (IFRG) is, with respect to any specified amount, any group of entities if such amount is paid or incurred during a reporting year of such group with respect to which such group prepares consolidated financial statements with respect to such year and the average annual aggregate payment amount for the three-year period ending with such reporting year exceeds $100 million.
- If foreign corporation elects to treat specified amounts as ECI (which is deemed to be attributable to U.S. permanent establishment) such foreign corporation is allowed a deduction for ''deemed expenses.''
- ''Deemed expenses'' are, with respect to any specified amount, an amount such that the ''net income ratio'' of the foreign corporation equals the net income ratio of the IFRG with respect to the product line to which the specified amount relates.
- ''Net income ratio'' is the ratio of net income (other than interest income, interest expense, and income taxes) to revenue.
- Amounts taken into account for determining deemed expenses and net income ratio are only the revenues and expenses of the IFRG's foreign members derived from and with respect to: (1) persons who are not IFRG members; and (2) members of the IFRG which are (or are treated as) a domestic corporation for purposes of the provision.
- Foreign corporation that elects to treat specified amounts as ECI also entitled to a credit under §906(a) for foreign income taxes paid or accrued that is limited to 80% of such amount of taxes paid or accrued and determined without regard to §906(b)(1).
- Specified amount paid, incurred, or received by a foreign corporation in connection with the conduct of a U.S. trade or business (other than one deemed pursuant to the provision) treated for purposes of the provision as an amount paid, incurred, or received, respectively, by a domestic corporation.
- Effective for amounts paid or incurred after December 31, 2018.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Note that the legislative text to the Senate version of the Tax Cuts and Jobs Act was released on November 20, 2017, but this column did not have time to incorporate a summary of the Senate bill before submission for publication.

Public Law No.: P.L. 115-97 (Bill No.: H.R. 1)

Name: An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.

Sponsor: Brady (R-TX)

Action: Enacted on December 22, 2017.

Provisions: The public law amends provisions of the Internal Revenue Code. The international tax provisions of the public law:

- Reduces the corporate income tax rate to 21%.
- Enacts new §245A to provide a deduction for the ''foreign-source portion'' of a dividend received from a ''specified 10%-owned foreign corporation'' by a domestic corporation which is U.S. shareholder with respect to such foreign corporation.
  - A ''specified 10-percent owned foreign corporation'' means any foreign corporation with respect to which any domestic corporation is a U.S. shareholder. A specified 10%-owned foreign corporation does not include a PFIC that is not a CFC.
  - The ''foreign-source portion'' of a dividend is an amount which bears the same ratio to the dividend as the ''undistributed foreign earnings'' of the specified 10%-owned foreign corporation bears to the total ''undistributed earnings'' of such foreign corporation.
  - The ''undistributed earnings'' is the amount of earnings and profits (E&P) (computed in accordance with §964(a) and §986) of the specified 10%-owned foreign corporation as of the close of the tax year in which the dividend is distributed and without diminution by reason of dividends distributed during such tax year.
  - The ''undistributed foreign earnings'' is the portion of undistributed earnings that is not attributable to income effectively connected with the conduct of a U.S. trade or business, or dividends received (directly or through a wholly owned foreign corporation) from a domestic corporation at least 80% of the stock of which (by vote and value) is owned (directly or through such wholly owned foreign corporation) by the specified 10%-owned foreign corporation.
  - Credits or deductions for foreign taxes (including withholding taxes) paid or accrued with respect to any dividend benefiting from the §245A deduction are disallowed.
  - Deduction under §245A does not apply to any ''hybrid dividend'' received by a U.S. shareholder from a CFC. A ''hybrid dividend'' is an amount received from a CFC (that otherwise would be eligible for the §245A deduction) for which the CFC receives a deduction (or other tax benefit) with respect to any foreign income, war profits, or excess profits taxes imposed by any foreign country or possession of the U.S.
  - New §245A applies to the distributions made after December 31, 2017.
- Enacts new §904(b)(5) to provide, in the case of a domestic corporation which is a U.S. shareholder with respect to a specified 10%-owned foreign corporation, that such U.S. shareholder's §904(a) limitation is determined without regard to the foreign-source portion of any dividend received from a specified 10%-owned foreign corporation and any deductions properly allocable or apportioned to income (other than amounts includible under §951(a)(1) or §951A) with respect to stock of a specified 10%-owned foreign corporation or such stock to the extent income with respect to such stock is other than amounts includible under §951(a)(1) or §951A.
  - New §904(b)(5) applies to deductions with respect to taxable years ending after December 31, 2017.
- Enacts new §1248(j) to treat, in the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for 1 year or more, any amount received by the domestic corporation which is treated as a dividend under §1248 as a dividend for purposes of applying §245A deduction.
  - New §1248(j) applies to sales or exchanges after December 31, 2017.
- Enacts new §964(e)(4) to address the foreign-source portion of any amount received by the selling CFC treated as a dividend under §964(e)(1) in the case of the sale or exchange by a CFC of stock in another foreign corporation held for 1 year or more.
  - New §964(e)(4) requires a U.S. shareholder with respect to the selling CFC to include in gross income its pro rata share of such amount of deemed subpart F income and allows the U.S. shareholder the deduction under §245A with respect to such amount of subpart F income included in gross income in the same manner as if such amount of subpart F income were a dividend received by the shareholder from the selling CFC.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- New §964(e)(4) applies to sales or exchanges after December 31, 2017.

- Enacts new §961(d) to provide that if a domestic corporation receives a dividend from a specified 10%-owned foreign corporation, solely for purposes of determining loss on any disposition of stock of such foreign corporation, the domestic corporation's basis in the stock of the foreign corporation shall be reduced (but not below zero) by the amount of any deduction allowable under §245A with respect to such stock.
  - New §961(d) applies to distributions made after December 31, 2017.

- Enacts new §91 to provide that if a domestic corporation transfers substantially all of the assets of a foreign branch to a specified 10%-owned foreign corporation with respect to which it is a U.S. shareholder after such transfer, the domestic corporation shall include in gross income an amount equal to the ''transferred loss amount'' with respect to such transfer.
  - ''Transferred loss amount'' is, with respect to any transfer of substantially all of the assets of a foreign branch, the excess (if any) of the sum of losses incurred by the foreign branch after December 31, 2017 with respect to which a deduction was allowed over the sum of any taxable income of such branch after the taxable year in which the loss was incurred and any amount which is recognized under §904(f)(3) on account of the transfer.
  - New §91 applies to transfers after December 31, 2017.

- Repeals the active trade or business exception of §367(a)(3) effective for transfers after December 31, 2017.

- Amends §965 to impose a transition tax by increasing the subpart F income of a ''deferred foreign income corporation'' in the last taxable year before January 1, 2018 by the greater of the ''accumulated post-1986 deferred foreign income'' as of November 2, 2017 or as of December 31, 2017.
  - A ''deferred foreign income corporation'' with respect to any U.S. shareholder is any ''specified foreign corporation'' (SFC) which has ''accumulated post-1986 deferred foreign income.''
  - A ''specified foreign corporation'' is any CFC and any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder (determined without regard to §958(b)(4)).
  - ''Accumulated post-1986 deferred foreign income'' means the ''post-1986 earnings and profits'' except to the extent such earnings are attributable to income effectively connected with the conduct of a trade or business within the U.S. or that would be excluded from the gross income of a U.S. shareholder under §959 if distributed.
  - ''Post-1986 earnings and profits'' is the E&P of the foreign corporation (computed in accordance with §964(a) and §986), and by only taking into account periods when the foreign corporation was a specified foreign corporation) accumulated in taxable years beginning after December 31, 1986, and determined as of November 2, 2017 or as of December 31, 2017, whichever is applicable, without diminution by reason of dividends distributed during the taxable year ending on the applicable date.
  - In the case of a taxpayer who is a U.S. shareholder with respect to at least one deferred foreign income corporation and at least one E&P deficit foreign corporation, the amount which would otherwise be taken into account under §951(a)(1) by reason of §965 shall be reduced by the amount of such U.S. shareholder's aggregate foreign E&P deficit allocated to such deferred foreign income corporation.
  - Cash and cash equivalents taxed at 15.5% and the remainder would be taxed at 8% with the option to pay the tax in eight equal installments.

- Repeals §902 deemed paid foreign tax credit and §955 inclusion of withdrawal of previously excluded subpart F income from qualified shipping investment, both effective December 31, 2017.

- Amends §954(a) and §954(g) to repeal treatment of foreign base company oil related income as subpart F income effective for taxable years of foreign corporations beginning after December 31, 2017.

- Amends §958(b) to remove the restriction under §958(b)(4) on attribution of stock owned directly or indirectly by a foreign partner, beneficiary, or shareholder to a U.S. partnership, trust, estate, or corporation as provided by §318(a)(3); effective for taxable years of foreign corporations beginning before January 1, 2018, and each subsequent taxable year of such foreign corporations.

- Amends §951(a)(1) to eliminate the requirement that a CFC must be controlled for 30 days before subpart F inclusions apply effective for taxable years of foreign corporations beginning after December 31, 2017.

- Enacts new §951A to require a U.S. shareholder to include in gross income such shareholder's ''global intangible low-taxed income'' for any taxable year of such U.S. shareholder.
  - ''Global intangible low-taxed income'' is the

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

excess, if any, of the U.S. shareholder's "net CFC tested income" for that taxable year over the U.S. shareholder's "net deemed tangible income return" for that taxable year.

- "Net deemed tangible income return" is the excess of 10% of the aggregate of the U.S. shareholder's pro rata share of the "qualified business asset investment" of each CFC over the amount of interest expense taken into account to determine the U.S. shareholder's "net CFC tested income" to the extent the interest income attributable to the expense is not taken into account to determine the U.S. shareholder's "net CFC tested income."
- "Net CFC tested income" is the excess, if any, of the U.S. shareholder's aggregate pro rata share of any "tested income" of each CFC, over the U.S. shareholder's aggregate pro rata share of any "tested loss" of each CFC.
- A CFC's "tested income" is the excess, if any, of: (1) its gross income (other than ECI, subpart F gross income, any gross income excluded from foreign base company income and insurance income by reason of §954(b)(4), related-party dividends (as defined in §954(d)(3))), and any foreign oil and gas extraction income (as defined in §907(c)(1)) over (2) deductions (including taxes) properly allocable to such gross income under rules similar to those of §954(b)(5).
- A CFC's "tested loss" is the excess of: (1) properly allocated and apportioned deductions; over (2) gross income taken into account in determining tested income.
- A CFC's "qualified business asset investment" is the aggregate of its adjusted bases in tangible property used in the production of tested income ("specified tangible property") that is: (1) used in a trade or business of the CFC, and (2) of a type with respect to which a deduction is allowed under §167.

- Amends §960 to deem a domestic corporation that includes an amount in gross income under §951A to have paid foreign income taxes equal to 80% of such domestic corporation's "inclusion percentage" multiplied by the aggregate foreign income taxes paid or accrued by CFCs that are properly attributable to tested income taken into account by the domestic corporation under §951A (defined as "tested foreign income taxes").
  - "Inclusion percentage" is the ratio of the domestic corporation's "global intangible low-taxed income" to its aggregate tested income.
- Amends §904 to add a new separate limitation category for "global intangible low-taxed income" and deny carryover of excess foreign taxes paid or accrued with respect to such separate limitation category.
- Amends §78 to compute the §78 gross-up for the amount of §960 deemed paid credit for taxes paid or accrued with respect to global intangible low-taxed income as 100% of the amount of such foreign income taxes paid or accrued by the CFC.
  - New §951A and the amendments to §960, §904, and §78 effective for taxable years of foreign corporations beginning after December 31, 2017.
- Enacts new §250 to allow any domestic corporation a deduction equal to the sum of (1) 37.5% of the domestic corporation's "foreign-derived intangible income," plus (2) 50% of the global intangible low-taxed income included in the domestic corporation's gross income under §951A, and the amount treated as a dividend under §78 attributable to "global intangible low-taxed income."
  - For taxable years beginning after December 31, 2025, the deduction is equal to 21.875% of "foreign-derived intangible income" and 50% of "global intangible low-taxed income."
  - "Foreign-derived intangible income" is the amount that bears the same ratio to "deemed intangible income" as "foreign-derived deduction eligible income" bears to "deduction eligible income."
  - "Deemed intangible income" means the excess, if any, of the domestic corporation's "deduction eligible income" over its "deemed tangible income return."
  - "Deemed tangible income return" means 10% of the corporations "qualified business asset investment" (as defined in §951A).
  - "Deduction eligible income" means the excess of a domestic corporation's gross income (other than subpart F gross income, global intangible low-taxed income, any financial services income (as defined in §904(d)(2)(D)), any dividend received from a corporation which is a CFC of the domestic corporation, any domestic oil and gas extraction income, and any foreign branch income (as defined in §904(d)(2)(J)), over the deductions (including taxes) properly allocable to such gross income.
  - "Foreign-derived deduction eligible income" means "deduction eligible income" derived in connection with (1) property which is "sold" to non-U.S. persons for "foreign use" (any use, consumption, or disposition not within the U.S.) or (2) services provided to any persons, or with respect to any property, not located in the U.S.
    - "Sold" for these purposes include any lease, license, exchange, or other disposition.
  - New §250 effective for taxable years beginning after December 31, 2017.

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.

ISSN 0090-4600

- Amends §163(j) to limit the deduction for any taxable year for business interest to the sum of (1) business interest income, (2) 30% of the ''adjusted taxable income,'' and (3) floor plan financing interest.
  - Business interest income means any interest paid or accrued on indebtedness properly allocable to a trade or business (does not include investment interest as defined by §163(d)), but excludes trade or business of performing services as an employee, electing real property trade or business (as defined in §469(c)(7)(C)), electing farming business (as defined in §263A(e)(4)), and trade or business conducted by certain regulated public utilities.
  - Floor plan financing interest is interest paid or accrued on indebtedness to finance acquisition of motor vehicles held for sale or lease and secured by the acquired inventory.
  - Adjusted taxable income is taxable income computed without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business, (2) any business interest or business interest income, (3) amount of any NOL deduction under §172, (4) amount of any deduction allowed under §199A, and (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.
  - Provides for partnership rule that applies the limitation at the partnership level and any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership.
  - Taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million are exempted from the limitation.
  - Amount of business interest expense deduction disallowed by the limitation for the taxable year treated as business interest paid or accrued in the succeeding taxable year.
  - Amended §163(j) effective for taxable years beginning after December 31, 2017.
- Enacts new §267A to deny a deduction for any ''disqualified related party amount'' paid or accrued pursuant to a ''hybrid transaction'' or by, or to, a ''hybrid entity.''
  - ''Disqualified related party amount'' means any interest or royalty paid or accrued to a related party to the extent that (1) there is no corresponding inclusion to the related party under the tax law of the country where the related party is resident for tax purposes, or (2) the related party is allowed a deduction with respect to the amount under the tax law of the residence country.
  - A ''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 Federal income tax purposes and which are not so treated under the tax law of the residence country of the recipient (or the country where the recipient is subject to tax).
  - A ''hybrid entity'' means any entity that is either (1) treated as fiscally transparent for Federal income tax purposes but is not so treated in the country where the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the country where the entity is resident for tax purposes or is subject to tax, but is not so treated for purposes of Federal income tax.
  - Treasury has broad authority to issue regulations or other guidance as may be necessary or appropriate to carry out the purpose of §267A.
  - New §267A effective for taxable years beginning after December 31, 2017.
- Enacts new §59A to impose on each ''applicable taxpayer'' a ''base erosion minimum tax amount'' that is in addition to any other income tax imposed on such applicable taxpayer.
  - ''Applicable taxpayer'' is a taxpayer which (1) is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation, (2) the average annual gross receipts of which for the 3-taxable-year period ending with the preceding taxable year are at least $500 million, and (3) the ''base erosion percentage'' of which for the taxable year is 3% or more (2% or more in the case of applicable taxpayers who are banks and securities dealers).
    - An aggregation rule applies for determining an applicable taxpayer and computing the base erosion percentage such that all persons treated as a single employer under §52(a) are treated as one person, except that in applying §1563 for purposes of §52, the exception for foreign corporations under §1563(b)(2)(C) is disregarded.
  - The ''base erosion minimum tax amount'' for any taxable year beginning in calendar year 2018 is the excess (if any) of 5% of ''modified taxable income'' for the taxable year over the regular tax liability for the taxable year reduced (but not below zero) by the excess, if any, of credits allowed under Chapter 1 over the sum of (i) the credit allowed under §38 (general business credits) allocable to the research credit plus (ii) ''applicable §38 credits'' (not to exceed 80% of the lesser of such credits or the base erosion minimum tax determined without taking into account such applicable §38 credits).

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

- Tax rate increased to 10% after the first taxable year.
- For taxable years beginning after December 31, 2025, the tax rate is increased to 12.5% and regular tax liability is reduced by an amount equal to all credits allowed under Chapter 1.
- Increased rates of 6%, 11% and 13.5%, respectively, for banks and securities dealers.

- The ''base erosion minimum tax amount'' for any taxable year beginning in calendar year 2018 is the excess (if any) of 5% of ''modified taxable income'' for the taxable year over the regular tax liability for the taxable year reduced (but not below zero) by the excess, if any, of credits allowed under Chapter 1 over the sum of (i) the credit allowed under §38 (general business credits) allocable to the research credit plus (ii) ''applicable §38 credits'' (not to exceed 80% of the lesser of such credits or the base erosion minimum tax determined without taking into account such applicable §38 credits).
- ''Modified taxable income'' is taxable income determined under Chapter 1 without regard to any ''base erosion tax benefit'' with respect to any ''base erosion payment,'' and without regard to any ''base erosion percentage'' of any NOL allowed under §172 for the taxable year.
- A ''base erosion tax benefit'' with respect to a ''base erosion payment'' is:
  - Any deduction allowed for an amount paid or accrued by the taxpayer to a foreign related party with respect to which a deduction is allowable;
  - Any deduction allowed for depreciation (or amortization in lieu of depreciation) with respect to property acquired by the taxpayer from a foreign related party with respect to an amount paid or accrued by the taxpayer to the foreign related party in connection with acquisition by the taxpayer of property from such person of a character subject to the allowance for depreciation (or amortization in lieu of depreciation);
  - Any reduction under §803(a)(1)(B) in the gross amount of premiums or other consideration on insurance and deduction under §832(b)(4)(A) from the amount of gross premiums for any premium or other consideration paid or accrued by the taxpayer to a foreign related party for reinsurance payments taken into account under §803(a)(1)(B) or §832(b)(4)(A);
  - Any reduction in gross receipts in computing gross income of the taxpayer for an amount paid or accrued by the taxpayer to a surrogate foreign corporation which is a related party of the taxpayer (but only if such person first becomes a surrogate foreign corporation after November 9, 2017) or a foreign person which is a member of the same expanded affiliated group as the surrogate foreign corporation.
- A related party is any 25% owner of the taxpayer, any person who is related to the taxpayer or any 25% owner of the taxpayer, within the meaning of §267(b) or §707(b)(1), and any other person related to the taxpayer within the meaning of §482.
- Base erosion payments do not include:
  - Cost of goods sold (COGS), generally excluded except for amounts paid to a surrogate foreign corporation (where status obtained after November 9, 2017) or a member of its expanded affiliated group, that result in a reduction of the gross receipts of the taxpayer.
  - Excludes any payment made pursuant to a derivative with respect to which the taxpayer marks to market gains or losses (i.e., ''qualified derivative payment'')
  - Certain service fees if paid or incurred for services meeting requirements for services cost method under §482, without regard to the requirement that services did not contribute significantly to fundamental risks of business success or failure
  - Amounts of FDAP subject to tax under §871(a) and §881(a) (proportionate amount to the extent withholding reduced by a tax treaty)
- ''Applicable §38 credits'' refers generally to the low-income housing credit, the renewable electricity production credit and the investment credit, but only to the extent properly allocable to the energy credit.
- ''Base erosion percentage'' is the percentage determined by dividing the aggregate amount of ''base erosion tax benefits'' of the taxpayer for the taxable year by the aggregate amount of deductions allowed for the taxable year (excluding the deductions allowed under §172, §245A, and §250, deductions for amounts paid or accrued for services to which the services cost exception from base erosion payment applies, and deductions for qualified derivative payments which are not treated as base erosion payments).
- New §59A effective for base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

- Repeals the fair market value method of interest expense apportionment under §864(e), effective for taxable years beginning after December 31, 2017.

- Introduces new §904(d)(2)(J) to create a separate limitation category for foreign branch income (defined as business profits attributable to one or more qualified business units in one or more foreign countries), effective for taxable years begin-

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

ning after December 31, 2017.

- Foreign branch income that constitutes passive income, however, would continue to be included in the passive limitation category.

- Amends §863(b) to source income from sales of inventory produced by the taxpayer within and sold or exchanged without the U.S., or produced by the taxpayer without and sold or exchanged within the U.S., solely on the basis of the production activities with respect to the property, effective for taxable years beginning after December 31, 2017.
- Amends §1297(b)(2)(B) to restrict insurance business exception to passive foreign investment company rules, effective for taxable years beginning after December 31, 2017.
- Amends §1(h)(11) to deny preferential qualified dividend income treatment for dividends received from a corporation which first becomes a surrogate foreign corporation within the meaning of §7874(a)(2)(B) (other than a foreign corporation treated as a domestic corporation under §7874(b)) after December 22, 2017.
- Enacts new §864(c)(8) to treat the portion of gain (or loss) from the sale or exchange of an interest in a partnership which is engaged in a U.S. trade or business as effectively connected income (ECI) to the extent the gain (or loss) from the sale or exchange of the underlying assets held by the partnership would be treated as ECI allocable to such partner, effective for sales, exchanges, and dispositions on or after November 27, 2017.
- Amends §1446 to require the purchaser of a partnership interest to withhold 10% of the amount realized on the sale or exchange of the partnership interest if any portion of the gain (if any) on the disposition would be treated under §864(c)(8) as ECI, unless the transferor certifies that the transferor is not a foreign person, effective for sales, exchanges, and dispositions after December 31, 2017.

Bill No.: H.R. 5108

Name: No Tax Breaks for Outsourcing Act

Sponsor: Doggett (D-TX) and 25 co-sponsors

Action: Introduced in the House of Representatives on February 27, 2018.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to provide for current year inclusion of net CFC tested income, and for other purposes. The international tax provisions of the bill would:

- Amend §951A to repeal exception for net deemed tangible income return to require as current year inclusion in gross income of a United States shareholder under §951A such shareholder's net CFC tested income for the taxable year.
  - Eliminate deduction under §250 allowed to a domestic corporation with respect to §951A current year inclusion of net CFC tested income and foreign-derived intangible income.
  - Determine net CFC tested income without regard to high-tax foreign income.
  - Repeal exclusion of foreign oil and gas extraction income from the determination of tested income of a CFC.
  - Would apply to taxable years beginning after December 31, 2017.
- Introduce new §163(n) to limit the deduction for interest paid or accrued by a domestic corporation that is a member of an international financial reporting group ("IFRG") to the sum of (1) the "allowable percentage" of 110% of the excess (if any) of the net interest expense, and (2) interest income for the taxable year.
  - An IFRG is, with respect to any reporting year, any group of entities which (1) includes (i) at least one foreign corporation engaged in a U.S. trade or business, or (ii) at least one domestic corporation and one foreign corporation, (2) prepares consolidated financial statements with respect to such year, and (3) reports in such statements average annual gross receipts for the three-reporting-year period ending with such reporting year in excess of $100 million.
  - The allowable percentage is the ratio (expressed in percentage and not greater than 100%) of the domestic corporation's "allocable share" of the IFRG's reported net interest expense, over the domestic corporation's reported net interest expense.
  - Domestic corporation's allocable share of IFRG's reported net interest expense for any reporting year is computed as the domestic corporation's EBITDA as a percentage of the IFRG's EBITDA multiplied by the IFRG's reported net interest expense.
  - IFRG's reported net interest expense is the aggregate interest expense over aggregate interest income reported in the IFRG's consolidated financial statements. Domestic corporation's reported net interest expense is interest expense over interest income reported in the books and records of the IFRG which are used in preparing the IFRG's consolidated financial statements.
  - IFRG's EBITDA is the amount as determined in the IFRG's consolidated financial statements, and the domestic corporation's EBITDA is the amount as determined in the books and records of the

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

IFRG which are used in preparing the IFRG's consolidated financial statements.
- Consolidated financial statement is generally a financial statement which is certified as being prepared in accordance with GAAP, IFRS, or any comparable method identified by Treasury/IRS, which is a 10-K, or an annual statement to shareholders, required to be filed with the U.S. SEC.
- Members of any group that file a consolidated return shall be treated as a single corporation for purposes of the limitation.
- Provide under new §163(o) that the lower of the limitation under §163(j) or §163(n) to apply, with amount of interest deduction disallowed for the taxable year by either provision to be carried forward for five years on a first-in, first-out basis.
- Would apply to taxable years beginning after December 31, 2017.

- Treat a foreign corporation as a U.S. corporation if: (1) such corporation would be a foreign corporation if the corporation would be a surrogate foreign corporation if §7874(a)(2) were applied by substituting "80 percent" for "60 percent," or if such corporation is an "inverted domestic corporation."

- Define an "inverted domestic corporation" as an entity if:
  - pursuant to a plan, the entity completes, after May 8, 2014, and on or before January 4, 2017, the direct or indirect acquisition of: (1) substantially all of the assets of a U.S. corporation or partnership; (2) substantially all of the trade or business assets of a U.S. corporation or partnership; or (3) substantially all of the U.S. trade or business assets of a foreign partnership; and
  - after all the acquisitions: (1) more than 50% of the stock (by vote or value) of the foreign corporation is held by the former shareholders or partners; or (2) the management and control of the expanded affiliated group that includes the foreign corporation occurs, directly or indirectly, primarily within the United States, and such expanded affiliated group has significant domestic business activities.
    - "Significant domestic business activities" would be defined as at least 25% of the employees, employee compensation, assets, or income being based or located or derived in the United States.
  - Except from the definition of "inverted domestic corporation" an entity if after the acquisition the expanded affiliated group that includes the entity has substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of the expanded affiliated group.
  - Would apply to taxable years ending after May 8, 2014.

- Amend §7701 to treat as domestic corporations certain foreign corporations managed and controlled primarily within the United States.

- Classify certain foreign corporations managed and controlled, directly or indirectly, primarily within the United States as domestic corporations.
  - Provide for regulations to determine what constitutes management and control primarily in the United States, but specify for those regulations to provide that management and control primarily occurs in the United States if substantially all the executive officers and senior management who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies are located primarily within the United States.

- Apply only to those foreign corporations whose stock is regularly traded on an established securities market or the aggregate gross assets of the corporation, including assets under management at any time during the taxable year or the preceding taxable year is at least $50 million.
  - Exclude such corporations if in the preceding taxable year, the corporation is not regularly traded on an established securities market and has, and is reasonably expect to continue to have, aggregate gross assets of less than $50 million and the Treasury Secretary has granted a waiver.

- Would be effective for taxable years beginning on or after the date which is 2 years after the date of the enactment.

★ ★ ★

Bill No.: S. 2459
Name: No Tax Breaks for Outsourcing Act
Sponsor: Whitehouse (D-RI)
Action: Introduced in the Senate on February 27, 2018.
Provisions: The bill is identical to the provisions included in H.R. 5108 (see above), which was introduced in the House of Representatives on February 27, 2018.

★ ★ ★

Bill No.: H.R. 5145
Name: Close Tax Loopholes That Outsource American Jobs Act

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

Sponsor: DeLaurio (D-CT)
Action: Introduced in the House of Representatives on March 1, 2018.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to eliminate tax preference for foreign profits by repealing the reduced rate of tax on foreign-derived intangible income and global intangible low-taxed income. The international tax provisions of the bill would:

- Eliminate deduction under §250 allowed to a domestic corporation with respect to §951A current year inclusion of global intangible low-taxed income and foreign-derived intangible income.
- Would apply to taxable years beginning after December 31, 2017.

★ ★ ★

Bill No.: H.R. 55651
Name: Puerto Rico Insurance Excise Tax Exemption Act of 2018
Sponsor: Gonzalez-Colon (R-Puerto Rico)
Action: Introduced in the House of Representatives on April 27, 2018.

Provisions: The bill aims to amend provisions of the Internal Revenue Code to exempt from the foreign insurance excise tax certain insurance policies issued by United States territory and possession insurers.

- ***Amend §4373 to exempt from the foreign insurance excise tax any policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by a partnership or corporation created or organized under the laws of any territory or possession of the United States, unless any of the risks, losses, or liabilities covered thereby are reinsured by another foreign insurer or reinsurer.***

- ***Would apply to premiums paid after the date of enactment.***

★ ★ ★

© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600