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INSIGHTS

CAN TAX AUTHORITIES DEMAND ACCESS TO AUDIT WORKPAPERS? CANADIAN EXPERIENCE FOLLOWS U.S. RULE

O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

PROPOSED AMENDMENTS TO F.A.T.C.A. SUGGEST REDUCING OR DEFERRING WITHHOLDING

AND MORE

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EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **Can Tax Authorities Demand Access to Audit Workpapers? Canadian Experience Follows U.S. Rule.** Recent victories in litigation have allowed the Canada Revenue Agency to review tax accrual workpapers of Canadian corporations, provided the request for access is not a "fishing expedition" attempting to find issues. In the U.S., the I.R.S. has enjoyed that power for many years. Sunita Doobay of Blaney McMurtry L.L.P., Toronto, examines the scope and limitations of the Canadian decisions. Stanley C. Ruchelman reviews case law in the U.S., the role of FIN 48, and the purpose behind Schedule UTP (reporting uncertain tax positions), which surprisingly is designed to limit examinations of tax accrual workpapers.

- **O.E.C.D. on Digital Business – Seriously?!** On February 13, 2019, the O.E.C.D. issued a discussion draft addressing the tax challenges of the digitalization of the economy and asked for feedback in a shockingly brief timeframe. Is the discussion draft – which, in many respects, mimics G.I.L.T.I. provisions and highlights the value of a market as a key determiner of profit allocation – a move away from value of functions? In a stealth way, it may be a precursor to a global B.E.A.T. Christian Shoppe of Deloitte Deutschland, Frankfurt, cautions that the ultimate destination of B.E.P.S. may be added complexity in tax laws and expanded opportunity for double taxation. Bad news for taxpayers; more work for tax advisers.

- **Tax Authorities Eye GSK-HUL Merger: Could Attract Tax on Long-Term Capital Gains and Brand Transfer.** GSK Consumer Healthcare India ("GSK India") is in the process of merging with Hindustan Unilever Ltd ("HUL") in the biggest deal in India's consumer packaged goods space, valued at approximately $4.5 billion. Although the transaction is structured to be tax-free for shareholders, plenty of room exists for the Indian tax authorities to assert tax from the companies: The transfer of a brand owned outside India may generate Indian tax to the extent its value stems principally from India. In addition, arm's length pricing for royalty payments and accompanying withholding tax issues also come into play. Sanjay Sanghvi and Raghav Kumar Bajaj of Khaitan & Co., Mumbai and New Delhi, discuss the global tax issues surrounding the transaction.

- **Proposed Code §864(c)(8) Regulations Codify Tax on Gain from Sale of Partnership Interest.** Enacted as part of the Tax Cuts and Jobs Act, Code §864(c)(8) codifies the holding in Rev. Rul. 91-32 and overturns the result of the Grecian Magnesite case. In late December 2018, the I.R.S. released proposed regulations containing guidance under new Code §864(c)(8). Among the points addressed in the proposed regulations are (i) rules to compute the amount of E.C.I. gain or loss, (ii) coordination with F.I.R.P.T.A. tax and withholding, (iii) interaction with income tax treaties, and (iv) anti-abuse rules. Fanny Karaman and Nina Krauthamer discuss these and other aspects of the proposed regulations.

- **Proposed Amendments to F.A.T.C.A. Suggest Reducing or Deferring Withholding.** In mid-December 2018, revised F.A.T.C.A. regulations were proposed by the I.R.S. Highlights included (i) the elimination of withholding on payments of gross proceeds, (ii) deferral, but not elimination, of withholding on foreign passthru payments, (iii) clarification of the definition of an investment entity, and (iv) changes to the consequence of hold-mail instructions on presumptions of residence. Galia Antebi explains all.

- **Who's Got the B.E.A.T.? A Playbook for Determining Applicable Taxpayers and Payments.** Code §59A imposes tax on U.S. corporations with substantial gross receipts when base erosion payments to related entities significantly reduce regular corporate income tax. The new tax is known as the base erosion and anti-abuse tax ("B.E.A.T."). In late December 2019, the I.R.S. proposed regulations that provide guidance for affected taxpayers. The proposed regulations provide a playbook for making required computations including (i) the gross receipts test to determine if the taxpayer meets the $500 million gross receipts requirement, (ii) the base erosion percentage test, (iii) how to apply the tests when a taxpayer is member of an Aggregate Group having members with differing year-ends, (iv) various computations to determine whether a non-cash transaction is considered to be a payment to a related party outside the U.S. or is outside the scope of the B.E.A.T., and (v) other exceptions from the B.E.A.T. In the first of a multi-part series, Rusudan Shervashidze and Stanley C. Ruchelman tell all.

- **Updates & Other Tidbits.** This month, Neha Rastogi and Nina Krauthamer look at interesting items of tax news from around the world: A new foreign investment law could ease the U.S.-China trade war, and another illegal State Aid investigation has been announced – this time over Dutch tax rulings issued to Nike and Converse.

We hope you enjoy this issue.

- The Editors

CAN TAX AUTHORITIES DEMAND ACCESS TO AUDIT WORKPAPERS? CANADIAN EXPERIENCE FOLLOWS U.S. RULE

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Tags
Attorney-Client Privilege
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U.S.

INTRODUCTION

When a Canadian or U.S.-based multinational finds itself under audit, the taxpayer and the tax authority are often at odds over what documentation is subject to disclosure and what remains beyond the prying eyes of the tax authority. In a landmark series of recent court cases in Canada, the Canada Revenue Agency ("C.R.A.") was given access to accounting workpapers and background documentation for transfer pricing reports to verify a position taken in a client's tax return. This is a major development in Canada. In the U.S., in contrast, the I.R.S. has been given access to workpapers and other information for many years. A comprehensive look at the long history of U.S. transparency may provide a roadmap of what Canadian-based multinationals should expect regarding matters of transparency.

TAX AUDITS

Whether a taxpayer is resident in Canada or the U.S., it may be subject to an administrative examination to determine whether tax liability has been calculated correctly in the tax return.

When the taxpayer is a large multinational, that tax audit involves a significant investment by the tax authorities in terms of staffing and resources. The examination portion of the audit may involve the issuance of information requests and possibly follow-up summonses that are intended to obtain data that may be used to test whether the taxpayer's claimed positions are justified under relevant tax law.

In a sense, the multinationals begin their investment long before the audit begins. They have sophisticated tax lawyers on staff and also retain sophisticated outside tax advisors. At the close of the year, the books and records of the enterprise are audited by a major accounting firm for the purpose of providing certification of the reported results.

When a tax examiner requests information regarding a specific transaction, the taxpayer may object on the grounds that the requested documentation is protected – either by attorney-client privilege or under the work product doctrine of privilege. The attorney-client privilege is a common law concept that dates back several centuries. The privilege protects information disclosed by the client to the attorney for the purpose of obtaining legal advice. The work product doctrine states that a party may not discover documents and tangible things prepared in anticipation of litigation or trial by a party or its representative. The work product privilege does not cover material assembled in the ordinary course of business or pursuant to public requirements that are unrelated to litigation or for other non-litigation purposes.[1]

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1 *Hickman v. Taylor*; 329 U.S. 495 (1947); *Wells Fargo v. U.S.*, Civil No. 10-mc- 57

A flash point for disclosure not covered by the work product doctrine is the tax provision analysis that forms part of the audit workpapers in support of a corporate taxpayer's published financial statements. When prepared by the audit firm, the tax provision analysis represents an outside professional's view regarding the expected tax exposure of a corporation in order to arrive at after-tax net profits. The analysis is designed to provide assurance that that the tax provision in the financial statement accurately portrays the financial condition of the company.

CANADIAN CASES

Source of C.R.A.'s Audit Powers

Subsection 231.1 of the Canadian Income Tax Act ("Act") grants broad powers to the C.R.A. to inspect, audit, or examine books, records, and inventory of a taxpayer. In carrying out its examination, the C.R.A. may issue a notice to a taxpayer requiring it to furnish information specified in the notice.[2] If a taxpayer refuses to comply, the C.R.A. may apply to the courts for a compliance order, if the requested information or document is not protected by solicitor-client privilege.[3]

Focus of C.R.A. Information Requests

In 2017 and 2018, a series of cases came before the Canadian Federal Court addressing the validity of a C.R.A. application for a compliance order seeking the production of tax workpapers and requesting the right to interview individuals who were officers and employees of the taxpayer.

In *MNR v. Cameco*,[4] the C.R.A. sought to interview 25 employees of Cameco to verify the information contained in its transfer pricing reports prepared by KPMG for tax years 2010 through 2012. In *BP Canada Energy Company v. MNR*,[5] the C.R.A. sought access to the taxpayer's tax accrual workpapers setting out its uncertain tax position for a specific year, not for the purpose of the initial examination of the tax return for that year but for the examination of tax returns filed for subsequent years. In *Canada (National Revenue) v. Atlas Tube Canada ULC*,[6] the C.R.A. sought access to a draft due diligence report prepared by EY, which had been prepared as part of an acquisition and reorganization of Atlas' corporate group.

Access to Interview Key Personnel of the Taxpayer

Cameco is one of the world's largest uranium producers and is headquartered in Saskatoon, Saskatchewan. Cameco has several foreign subsidiaries. In the Cameco case, the C.R.A. sought to interview 25 employees of Cameco and its related non-Canadian subsidiaries for purposes of substantiating a transfer pricing report prepared by KPMG for tax years 2010 through 2012. The employees were situated in Switzerland, the U.S., Barbados, and Canada. The C.R.A. offered to interview these individuals at their locations or by videoconference.

(D. Minn., June 4, 2013).

2 Section 231.2 of the Act.

3 Section 231.7 of the Act.

4 2017 F.C. 763.

5 2017 F.C.A. 61.

6 2018 F.C. 1086.

In the past, Cameco had granted the C.R.A. access to its personnel for assessment of tax years 2003 through 2006. The oral information obtained from the personnel led to a reassessment of those years that was subsequently challenged by Cameco. The matter was pending before the Tax Court of Canada when the C.R.A. applied for a compliance order seeking access to a larger number of Cameco's personnel for assessment of tax years 2010 through 2012. The Federal Court refused to issue a compliance order on the basis that issuing such order would prejudice Cameco:

> When the first audits were performed, Cameco agreed to have its personnel interviewed only by a CRA official. Those interviews were not recorded, though Cameco lawyers were allowed to be present during the interviews. Both the CRA and Cameco personnel took notes of the interviews. When the matter for those years proceeded to the Tax Court of Canada and Notices to Admit were served, it was found that the two parties had very different recollections of what was said at the oral interviews. . . . If the Minister's position is accepted, the CRA can compel oral interviews from as many persons as they see fit without any procedural limits. Oral interviews as sought on these facts at the audit stage would undermine procedural safeguards provided at the appeal stage. Furthermore, the Minister could use an isolated statement by an employee which the taxpayer would be forced to disprove at trial.

The C.R.A. requested to have a court reporter present during the interview process to prevent misinterpretation of information. However, the court rejected the request, as it would result in replicating an examination for discovery in a Tax Court proceeding with the C.R.A. hand picking interviewees instead of Cameco choosing its own officers for examination.

Access to Tax Workpapers for Future Audits

The *BP Canada* case is the first Canadian case to address an attempt by the C.R.A. to access a taxpayer's tax accrual workpapers without advancing any particular justification for their production. Tax accrual workpapers are papers created by or for independent auditors in order to assist in the process of certifying financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). Tax accrual workpapers are used to identify uncertain positions and provide for reserves that will allow an independent auditor to certify that financial statements fairly and accurately reflect the financial situation of the corporation under audit.

In the course of the C.R.A.'s examination of BP Canada for 2005, the examiner identified an issue relating to refund interest paid by the C.R.A. to BP Canada. The accounting turned out to be erroneous, as the refund interest payment should have been booked in 2005. During the examination process, several accounting entries in an account entitled "Interest Expense Taxes Payable – Disputed Accruals Account" came to surface. The C.R.A. examiner sought access to the tax accrual workpapers from BP Canada to support the entries in that account. BP Canada refused on the basis that the disclosure of tax accrual workpapers was unnecessary in the fact pattern as only refund interest was questioned by the examiner. That issue was resolved, leading BP Canada to contend in effect that the C.R.A. examiner was partaking in a "fishing expedition." Further, BP Canada argued that disclosure of its tax accrual workpapers would not only provide the C.R.A. with a roadmap to its uncertain tax positions but would also allow access to the analysis behind those positions.

BP Canada, therefore, appealed to the Federal Court of Appeal and the Chartered Professional Accountants of Canada ("C.P.A.C.") participated as an intervener in light of the broad scope of the issue. The C.P.A.C. argued that the formal requests for the production of tax accrual workpapers should not be routine and uncontrolled, and that the obligation to produce these papers to the C.R.A. would undercut the public interest role of C.P.A.C. members in certifying financial statements. The court summarized the concerns of the C.P.A.C. in the following language

> Professional accountants have a direct role in ensuring a degree of confidence in publicly-traded corporations' financial statements through independent auditing. Because they act in the public interest, they are subject to professional and ethical obligations, such as an obligation of integrity, a duty of care, and a duty of objectivity. . . . In keeping with those obligations, professional accountants have to review [tax accrual workpapers] prepared by the corporations which they audit in addition to preparing their own [tax accrual workpapers].
>
> [The C.P.A.C.] thus fears that the order, if allowed to stand, will cause corporations to 'hesitate to voluntarily and fully disclose their tax risks.' Moreover, routine access by the Minister to subjective opinions on tax risks may 'discourage corporations from preparing such analysis in order to protect it from disclosure.'
>
> [The C.P.A.C.] invites the Court to interpret subsection 231.1(1) of the Act in light of 'the global context of rules of professional ethics and financial reporting.' This means that only objective information would be subject to production, such as the 'disclosure of all transactions that could have a material impact on the corporation's tax liability, without identifying the degree of tax risk that any of those transactions may have.'

Notwithstanding the legal arguments submitted by the C.P.A.C., the Federal Court of Appeal held that a taxpayer could be ordered to produce tax accrual workpapers where the tax accrual workpapers pertain to a specific issue under an existing audit. However, the deeper issue was whether subsection 231.1(1) allows general and unrestricted access to this information. In the *BP Canada* case, the C.R.A.'s request was specific to an existing audit. However, there was no existing audit pertaining to the information requested, and the C.R.A. sought access to BP Canada's uncertain tax positions for the purpose of using these positions to facilitate future audits. Therefore, the court held that BP Canada could not be compelled to produce the tax accrual workpapers.

Access to Workpapers in an Ongoing Audit

In the *Atlas Tube* case, the C.R.A. sought a compliance order application before the Federal court seeking the release of a due diligence report prepared by EY pursuant to a reorganizational transaction in 2012 which included the purchase of an unrelated company by Atlas's parent corporation, a U.S. entity. The due diligence report was prepared by the accounting firm, EY, to understand whether the Canadian sister corporations and Atlas had sufficient tax losses to offset the future revenue of the newly acquired entity. The C.R.A. initiated an examination of the tax return of Atlas. in the course of which it requested a copy of the due diligence report. Atlas argued that the report was cloaked under solicitor-client privilege and therefore could not be released.

The Federal Court concluded that dominant purpose of the report was to inform the decision whether to proceed with the transaction and at what price. Because the purpose of the report was not to obtain legal advice, the court held that the solicitor-client privilege did not apply. The report included, *inter alia*, the tax attributes of the target corporations and the material tax exposures resulting from the prior Canadian tax filings including an assessment of the probability that the filing positions leading to the tax exposures would be sustained if challenged by the C.R.A. The court concluded that the assessment and evaluation represent accounting opinions by EY, which cannot be characterized as prepared for the purpose of obtaining legal advice on the structuring of the transaction.

The court also distinguished the *BP Canada* case on the basis that the report requested in the *Atlas* case was made in the context of an active examination of particular issues unlike the *BP Canada* case where the purpose was to facilitate future audits.

U.S. EXPERIENCE

Financial Accounting Conceptual Background

SFAS 109 (Accounting for Income Taxes)

Financial accounting concepts of income recognition are not identical to U.S. tax accounting concepts. As a result, pre-tax income for financial accounting standards may not look anything like the taxable income on a corporate tax return. The disparity could result from a variance in cost basis resulting from the computation of depreciation under two different sets of accounting standards or may reflect a mere difference in income or expense recognition rules.

To illustrate, assume an item of depreciable property is sold for a combination of cash and purchase money notes held by the seller calling for payment over time. For financial accounting purposes, all gain is recognized immediately upon the sale. That is the time when income or gain is more likely than not realized. For tax purposes, the recognition of gain may be deferred under rules applicable to an installment sale, where gain is recognized as payments are received. In addition, the amount of the gain may be measured differently. If a risk exists regarding the likelihood that full payment of the installment notes will be received, the amount of the gain for financial statement purposes may be adjusted for a reserve that takes into account the risk of full and timely payments of the promissory notes issued by the purchaser. No such reserve is generally allowed for tax purposes, which defers the effect of a potential loss until the loss occurs.

FIN 48 (Accounting for Uncertainty in Income Taxes)[7]

The foregoing example related to the sale of property is a relatively straightforward fact pattern. The complexity increases when a loss or credit is derived from one transaction but is used immediately to reduce tax otherwise due on income from another transaction. The reduction in tax resulting from the validity of the loss is viewed

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[7] Now codified in accounting literature as ASC 740-10.

as a tax position for financial statement purposes. Deciding whether the tax benefit from the loss is recognized and determining how much is recognized are accounting decisions made under the principles of FIN 48.

FIN 48 is an interpretation of SFAS 109 regarding the calculation and disclosure of reserves for uncertain tax positions. The evaluation of a tax position in accordance with FIN 48 is a two-step process:

1. The first step relates to recognition of a benefit arising from a tax position. In this step, the company determines whether it is more likely than not that a tax position will be sustained based on the technical merits of the position upon conclusion of examinations, I.R.S. appeals procedures, and litigation processes. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the company presumes that the position will be examined by the appropriate taxing authority and that the examiner has full knowledge of all relevant information.

2. The second step in the evaluation process is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which any of the following occurs:

- The threshold is met (*e.g.*, by virtue of another taxpayer's favorable court decision)
- The position is "effectively settled" by virtue of the closing of an examination where the likelihood of the taxing authority reopening the examination of that position is remote
- The relevant statute of limitations expires

Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 is reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the year of adoption, presented separately.

Arthur Young & Co. Case

In 1975, the I.R.S. began a routine examination to review Amerada Hess's corporate income tax liability for the tax years 1972 through 1974. When the audit revealed that the company made questionable payments of $7,830 from a "special disbursement account," the I.R.S. initiated a criminal investigation of Amerada's tax returns in addition to the civil examination. In that process, the I.R.S. issued an administrative summons to Arthur Young & Co., pursuant to Code §7602 as in effect prior to the adoption of the Internal Revenue Code of 1986.[8] The summons required

[8] All statutory references are to the Internal Revenue Code of 1986 ("Code") as

Arthur Young to make available to the I.R.S. all its Amerada Hess files, including its tax accrual workpapers. The client instructed Arthur Young not to comply with the summons.

"Financial statement audit firms have a public responsibility to ensure that a company issuing publicly-traded stock accurately reports its financial accounts to the public."

The I.R.S. commenced an action in Federal district court for enforcement of the summons. The district court found that Arthur Young's tax accrual workpapers were relevant to the I.R.S. investigation and refused to recognize an accountant-client privilege that would protect the workpapers.[9] The Court of Appeals for the Second Circuit agreed that the tax accrual workpapers were relevant to the I.R.S. investigation but held that the public interest in promoting full disclosure to public accountants and ensuring the integrity of the securities markets required protection for the work that such independent auditors perform for publicly-owned companies.[10] The court of appeals fashioned a work product immunity doctrine for tax accrual workpapers prepared by independent auditors in the course of compliance with Federal securities laws.

Ultimately, the Supreme Court held that the tax accrual workpapers were relevant to the I.R.S. audit and therefore discoverable.[11] In addition, the Supreme Court found that no accountant-client privilege exists under Federal or state law. Unlike an attorney, whose role is to represent a client in the most favorable light possible, financial statement audit firms have a public responsibility to ensure that a company issuing publicly-traded stock accurately reports its financial accounts to the public. In substance, the Supreme Court acknowledged that financial statement auditors have a responsibility to users of financial statement information. This responsibility can create an adverse relationship between the company and its auditors.

Announcement 2002-63

Having won its case against Arthur Young, the I.R.S. understood that total and complete access to tax accrual workpapers would inhibit a full analysis by the outside accountants. Consequently, it scaled back its demands to see accountants' tax accrual workpapers except in extraordinary circumstances. In Announcement 2002-63, the I.R.S. explained the circumstances in which tax accrual workpapers would be requested during the cause of an I.R.S. examination:

- Workpapers could be requested in the course of the examination of any return filed on or after July 1, 2002, claiming a tax benefit arising out of a listed transaction, which in broad terms is a tax shelter in the view of the I.R.S. If the listed transaction was disclosed on the taxpayer's tax return, the review is limited to those workpapers related to the listed transaction. On the other hand, if the listed transaction has not been disclosed on a tax return, the I.R.S. will request all tax accrual workpapers.
- If the I.R.S. determines that tax benefits have been claimed from multiple investments in listed transactions, the I.R.S., as a discretionary matter, may request all tax accrual workpapers. It does not matter whether the listed transactions were disclosed on a tax return.

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in effect at the time, unless otherwise stated.

9 *U.S. v. Arthur Young & Co.*, 496 F.Supp. 1152 (S.D.N.Y. 1980).

10 *U.S. v. Arthur Young & Co*, 677 F.2d 211 (2S Cir. 1982).

11 *U.S. v. Arthur Young & Co*, 465 U.S. 805 (1984).

- If there are reported financial accounting irregularities requiring a restatement of the earnings of a taxpayer that reported an investment of a listed transaction, the I.R.S. could request all tax accrual workpapers as a discretionary matter.

Textron Case

In 2003, the I.R.S. began an audit of Textron's tax return for 2001 and found that its subsidiary had participated in nine listed transactions that were potential tax shelters. In each of the nine instances, Textron purchased equipment from a foreign utility or transit operator and leased it back to the seller on the same day. The I.R.S. determined that these were sale-in, lease-out ("S.I.L.O.") transactions,[12] which are listed as potential tax shelters subject to abuse by taxpayers. The I.R.S. issued an administrative summons[13] to obtain the books, papers, records, or any other data that may be relevant to the inquiry.[14] Since Textron claimed benefits from multiple transactions, the I.R.S. sought all the workpapers for the years in question[15] from both Textron and its outside auditors, Ernst & Young. Textron refused to hand over its workpapers and intervened in the summons served on Ernst & Young.

The I.R.S. brought an enforcement action in connection with the administrative summons. Textron claimed that the documents listed in the summonses were protected from disclosure under the attorney work product doctrine. The main issue in the litigation was whether the documents being demanded were prepared routinely or in anticipation of litigation. In the latter case, the documents would be privileged.

The U.S. Federal District Court for the District of Rhode Island, which was the court of original jurisdiction, ruled that the work product privilege was applicable.[16] The decision was appealed by the I.R.S. to the First Circuit Court of Appeals.

The work product doctrine offers protection for documents by or at the direction of an attorney that are prepared in anticipation of litigation or for trial by or for another

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12 For an excellent discussion of a S.I.L.O. transaction, see Wood and Hollingworth, "SILOs and LILOs Demystified," *Tax Notes* (October 11, 2010), p. 195. According to the authors, through March 12, 2004, when U.S. tax law was revised to eliminate the tax benefits of these transactions, U.S. taxpayers were involved in at least 400 S.I.L.O. transactions, claiming tax deductions of more than $35 billion.

13 26 U.S.C. §7602 (2006).

14 In pertinent part, the subpoena served on Textron demanded the following documents:

> All accrual and other financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer's independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes.

15 I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (July 8, 2002).

16 *U.S. v. Textron Inc. & Subsidiaries*, 507 F. Supp. 2d 138 (D. R.I. 2007).

party or its representative.[17] A "because of" test is applied to determine whether a document is protected by the attorney work product doctrine. A document is protected if, in light of the nature of the document and the facts of a particular case, the document can be said to have been prepared because of the prospect of litigation. Conversely, a document is not protected from disclosure if it is prepared in the ordinary course of business or it would have been created in essentially similar form in the absence of the litigation. The work product doctrine applies in tax summons enforcement proceedings.[18]

Textron argued that the workpapers were prepared to ensure that a sufficient amount was set aside in the event of a dispute the I.R.S. The analysis of the tax positions in the return were conducted by the company's legal counsel. Textron argued that the analysis was prepared to analyze potential litigation with the I.R.S. over the very tax shelters that had been identified and the company's need to set aside reserves in case the tax benefits were disallowed by the I.R.S.

The I.R.S. argued that the work product privilege was lost because the workpapers also served a business or regulatory purpose – the accuracy of the published financial statements. Textron needed to prepare the same analysis to comply with the transparency rules applicable to capital markets in the U.S. It also argued that Textron could not have anticipated litigation at the time the accrual workpapers were prepared, and in any event, no specific litigation was identified by Textron. Finally, the I.R.S. argued that an adversarial relationship existed between the taxpayer and its independent auditor, so when the papers were shown to the audit firm, Textron caused the workpapers to lose any privilege that may have existed.

"A document is not protected from disclosure if it is prepared in the ordinary course of business or it would have been created in essentially similar form in the absence of the litigation."

A three-judge panel of the appeals court initially ruled in favor of Textron[19] regarding the application of the attorney work paper doctrine. The initial opinion acknowledged that Textron and the I.R.S. had a contentious relationship in regard to the examination of the company's tax returns. Evidence presented to the district court indicated that Textron was audited by the I.R.S. on a continuous basis. In every three-year audit cycle, hundreds of I.R.S. adjustments were made without challenge. Where adjustments were disputed, the matter was resolved through a conference with the audit team, by presentation of arguments to the I.R.S. Office of Appeals, or in litigation. The appeals court held that while not all aspects of a tax examination are adversarial, the resolution of disputes through administrative processes, including proceedings before the I.R.S. Appeals Office, is litigation. Consequently, the appeals court initially ruled in favor of Textron.

The I.R.S. timely petitioned the appeals court asking for review by the entire panel of judges in the court. The original decision by the appeals court was vacated, additional briefs were submitted, and *amicus curiae* briefs were filed by interested parties that might be affected by the ruling of the court. The full appeals court held that the Textron tax analysis workpapers were independently required by statutory and audit requirements and that the attorney work product privilege was not applicable.[20]

The final decision characterized the problem in the following terms:

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17 Fed. R. Civ. P. 26(b)(3)(A).

18 *Upjohn Co. v. U.S.*, 449 U.S. 383, 386 (1981).

19 553 F.3d 87 (1st Cir. 2009).

20 560 F.3d 513 (1st Cir. 2009).

> . . . [H]ow far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic . . . [in the context of] a document [that] is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation.

The appeals court looked to *Hickman v. Taylor* for guidance:

> Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference . . . This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways – aptly though roughly termed . . . as the 'work product of the lawyer.'

On this basis, the Supreme Court declared that the interrogatories, which sought witness interviews conducted by opponent's counsel in preparation for litigation, were protected by a qualified privilege. That privilege is now codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure regarding disclosure of material to the opposing side in litigation. The tax accrual workpapers simply did not meet this standard. The immediate motive of Textron in preparing the tax accrual workpapers was to fix the amount of the tax reserve on Textron's books and to obtain a clean financial opinion from its auditor. Merely because Textron wanted to be adequately reserved in the event of litigation does not mean that the workpapers were prepared for use in possible litigation. The workpapers were prepared to ensure that sufficient reserves were established to cover liabilities that might be determined in litigation.

The appeals court concluded that an experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation material. The fact that the documents were prepared by lawyers or reflected legal thinking is not sufficient to trigger work product protection, even if the subject matter of a document might conceivably be litigated. Those documents are merely another type of material that is assembled in the ordinary course of business or in compliance with public requirements unrelated to litigation. They do not have immunity from disclosure.

The appeals court decision for the majority ends with the following comments:

> Textron apparently thinks it is 'unfair' for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged. Virtually all discovery against a party aims at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery. . . .
>
> The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious. Textron's return is massive--constituting more than 4,000 pages--and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers.

It is because the collection of revenues is essential to government that administrative discovery, along with many other comparatively unusual tools, are furnished to the IRS. [Footnote omitted.]

Schedule UTP Reporting Uncertain Tax Positions

Having won the right to review tax accrual workpapers, the I.R.S. modified its approach by adopting a plan for transparency of corporate tax returns keyed to the tax return itself.

In a speech before the New York State Bar Association Tax Section Annual Meeting in New York City on January 26, 2010, then Commissioner Doug Schulman announced the introduction of Schedule UTP as a means of coordinating issue identification for tax purposes with the obligations imposed under FIN 48. I.R.S. statistics indicate that up to 25% of its time in large corporate audits is allocated to identifying issues rather than having a straightforward discussion with taxpayers about tax issues. The goal of the I.R.S. is to use the form to reduce the time it takes for I.R.S. examiners to find issues and complete an audit. It does this by assisting the I.R.S. in prioritizing the selection of issues and ensuring that the I.R.S. and taxpayers spend time discussing the law as it applies to the taxpayer's facts. Below is the plan that was announced by Commissioner Schulman:

> Reporting uncertain tax positions would be required at the time a return is filed by certain business taxpayers: those who have both a financial statement prepared under FIN 48 or other similar accounting standards reflecting uncertain tax positions and assets over $10 million. Under the Announcement, these taxpayers would be required to annually disclose uncertain tax positions in the form of a concise description of those positions and the maximum amount of US income tax exposure if the taxpayer's position is not sustained. By concise, we mean a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis.
>
> Let me say a few things about this proposal. We have taken what I believe is a reasonable approach. We could have asked for more . . . a lot more . . . but chose not to. We believe we have crafted a proposal that gives us the information we need to do our job without trying to get in the heads of taxpayers as to the strengths or weaknesses of their positions. . . .
>
> The proposal does not require the taxpayer to disclose the taxpayer's risk assessment or tax reserve amounts. We are asking for a list of issues that the taxpayer has already prepared for financial reporting purposes, in order to improve the efficiency and effectiveness of tax examinations. We are also looking for the maximum exposure, so we can allocate our exam resources appropriately. We need to have a sense of materiality and whether we should spend exam resources on an issue. The principal guidance for completing the form comes from the instructions published by the I.R.S.

A Schedule UTP is required if each of the following four requirements are met: (i) a corporate tax return is filed, (ii) an asset threshold is met, (iii) audited financial statements are prepared, and (iv) either a reserve is reported for a tax position or a reserve is not recorded because a decision has been reached to litigate the tax position if challenged. Each of these requirements is discussed below:

- **Corporate Tax Return Filed.** The corporation files a tax return on Form 1120, *U.S. Corporation Income Tax Return*; Form 1120-F, U.S. *Income Tax Return of a Foreign Corporation*; Form 1120-L, *U.S. Life Insurance Company Income Tax Return*; or Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*.

- **Asset Threshold.** The corporation has assets that equal or exceed $10 million. If the U.S. branch of a foreign corporation has less than $10 million in assets but the entire corporation meets that threshold, Schedule UTP must be filed.

- **Audited Financial Statements.** The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year. Audited financial statements mean financial statements on which an independent auditor has expressed an opinion, whether qualified, unqualified, disclaimed, or adverse, under G.A.A.P., I.F.R.S., or another country-specific accounting standard, including a modified version of any of the above. Compilations or reviewed financial statements – which may be prepared in the U.S. without the necessary audit steps to allow the audit firm to issue an opinion – are not audited financial statements for purposes of this test. If a corporation reconsiders whether a reserve is required for a tax position and eliminates the reserve in an interim audited financial statement issued before the tax position is taken in a return, the corporation need not report the tax position to which the reserve relates on Schedule UTP.

- **Reserve Recorded or Decision to Litigate.** The corporation has taken one or more tax positions taken on a tax return for the current or prior year and either it or a related party has recorded a reserve in audited financial statements, or a reserve is not recorded because the corporation expects to litigate the position. This is a two-step analysis: (i) defining a tax position and (ii) determining whether a reserve was taken for financial statement purposes.

A tax position taken on a tax return means a tax position that would result in an adjustment to a line item on any schedule or form attached to the tax return if the position is not sustained.

A tax position is based on the unit of account used to prepare the audited financial statements on which the reserve is recorded (or on which no reserve was recorded because of an expectation to litigate). A unit of account is the level of detail used in analyzing a tax position. The unit of account used by a G.A.A.P. or modified G.A.A.P. taxpayer for reporting a tax position on Schedule UTP must be the same unit of account used by the taxpayer for G.A.A.P. or modified G.A.A.P.

For a non-accountant, the term "unit of account" is not a clear term. However, an example in the instructions suggests that it means the method adopted by a corporation to report an item for accounting purposes. The example looks at two corporations, each independent of the other. Each conducts an independent research and development project, and each intends to claim a credit allowed for the outlays incurred in the activity. Many hurdles must be overcome to benefit from the credit and so the credit is a tax position. One corporation chooses each individual research project as the unit of account for G.A.A.P. financial reporting purposes, since the corporation accumulates information for the tax return at the project level and expects the I.R.S. to address the issues during an examination of each project separately. The other corporation determines that the appropriate unit of account for G.A.A.P. financial reporting purposes is the functional expenditures, based on the amount of its expenditures, the anticipated credits to be claimed, its previous experience, and the advice of its tax advisors. The method chosen by each corporation to accumulate and report information for G.A.A.P. purposes must be used when preparing the Schedule UTP.

A reserve is recorded when an uncertain tax position or a FIN 48 liability is stated anywhere in a corporation's or related party's financial statements, including footnotes and any other disclosures, and may be indicated by any of several types of accounting journal entries. The initial recording of a reserve will trigger the reporting of a tax position taken on a return. However, subsequent reserve increases or decreases with respect to the tax position will not trigger reporting.

Although the use of a net operating loss ("N.O.L.") or a credit carryforward is a tax position taken on a tax return, the use of the N.O.L. or credit carryforward in the carryforward year is not reported on Schedule UTP if the corporation previously reported the tax position that created or added to the N.O.L. or credit carryforward on Schedule UTP.

Once reportable tax positions are identified, they must be ranked by size and reported in order from greatest to least material. The amounts involved for each tax position need not be reported anywhere on Schedule UTP. The ranking of each tax position is determined on an annual basis and is the amount of U.S. Federal income tax reserve recorded for that position.

Finally, a concise description should be given of the tax position. This entails a very brief description of the relevant facts and information that can be reasonably expected to apprise the I.R.S. of the nature of the issue. The description should not include an assessment of the risks for the corporation or an analysis of legal authorities for or against the tax position in the return.

"An unfettered exercise of power can be challenged not only on the grounds laid down by the Federal Court in the* BP Canada *case but also on the basis that a demand violates the general principles of natural justice."

CONCLUSION

When Schedule UTP was first announced by the I.R.S. in 2010, Canadian tax advisers looked with disbelief at the transparency obligations imposed on applicable U.S. corporate taxpayers. Eight years later, the C.R.A. has won court cases giving it wide powers to require a taxpayer to produce documents relevant to identify issues for the year under examination. In comparison to U.S. practice, an unfettered exercise of power can be challenged not only on the grounds laid down by the Federal Court in the *BP Canada* case but also on the basis that a demand violates the general principles of natural justice. In the U.S., Schedule UTP shines a bright light on issues that were of concern at the time a set of audited financial statements were prepared. Access to workpapers, however, is limited to situations where factors suggest that corporate management has an appetite for aggressive tax planning.

O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

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O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

On February 13, 2019, the O.E.C.D. issued a discussion draft addressing the tax challenges of the digitalization of the economy[1] and asked for feedback – in a shockingly brief timeframe – by March 1. Although the deadline is now generously extended to March 6, the draft itself is nothing to scoff at. Tax administrations and multinational enterprises ("M.N.E's.") should take this very seriously. Even organizations that do not the typically consider themselves digital businesses may be affected. Given that digital business was one of the first sectors identified by the B.E.P.S. Project, the current progression is troubling.

The draft has two *three* major sections:

1. **The Old Part.** The first provides for revised income allocation based on new nexus rules. In essence, the activity of a user, a local market intangible, or a significant economic presence should attract profits and thus taxes.

2. **The New Part.** The second provides for either a minimum taxation concept, following the global intangible low-taxed income ("G.I.L.T.I.") rules introduced in the U.S. from 2018 onwards, or transactional deduction barriers based on the level of taxation on the other end of the transaction.

3. **The Silent Part.** Actually, there are only two sections in the O.E.C.D. draft. Although it talks about base erosion payments, the draft does not dedicate a section to this topic and is expressively silent on the approach introduced by the U.S. – the base erosion anti-abuse tax ("B.E.A.T.")

PART ONE – TOTAL DISASTER

The starting point is the notion that U.S. digital giants should pay taxes in other countries. This is contrary to the typical arm's length standard, insofar as functions, risk-taking, and assets are typically centralized and profits and taxes should arise where the substance sits. Granted, this is not the reality when we remember the Cayman Islands. However, this is a U.S. problem in the end and one partially solved by G.I.L.T.I.

The ideas contained in the first part of the draft are meant to allow arbitrary taxation with no real local contribution. Take for example the local customers. If the headquarters performs the majority of the development, enhancement, maintenance, protection, and exploitation of intangibles ("D.E.M.P.E.") functions under the current

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1 O.E.C.D., "OECD Invites Public Input on the Possible Solutions to the Tax Challenges of Digitalisation," press release, February 13, 2019.

concept, the entitlement to the profit should reside with the headquarters. This is now supposed to be turned on its head, so that the location of customers should give rise to taxation on the profit – just because they sit in the country (a tremendous simplification).

This is nice for other economically developed O.E.C.D. members *vis-à-vis* the U.S. However, tax administrations in China, India, and other locations are waiting for this role to turn towards them. They would be happy to consider a local customer, supplier, or other economically important "contribution" to allow for income allocation. Hence, this first set of ideas, if it becomes real, will backfire.

Moreover, it will spill over to the traditional economy. For example, take a traditional consumer business running a limited risk distributor ("L.R.D.") abroad. Following the O.E.C.D. framework, the local tax administration notifies the business that it benefits from online reviews, local customers, and the importance of the local market. Now, the business must take steps to enact a profit split.

This leads us to the next problem: How to perform a profit split without traditional anchor points and without any reference to the arm's length principle? The answer is by relying on a largely non-functional mutual arbitration network.

Whether you are in a government, in a digital business, or even in a traditional economy, now is the time to eliminate the idea of "contribution." Otherwise, the ultimate result could be the arbitrary taxation of profits, anywhere in the world.

PART TWO – ADMINISTRATION WITH LITTLE EFFECT

The two main ideas in the second part of the draft (G.I.L.T.I. and deduction barriers) have one thing in common: a massive increase in administration. For 15 years, people have been saying that the job of a tax advisor will soon be obsolete, as machines will take over thanks to digitalization. However, the opposite seems to be coming true. Because of digitalization – or at least the taxation of the digital economy – the job will be safe.

In the case of G.I.L.T.I., the income of all subsidiaries must be determined according to the location of the headquarters and generally accepted accounting principles ("G.A.A.P."). This requires a lot of manual work.

In the case of deduction barriers, the following considerations must be made: Who is going to carry the client over the bar? Who will organize the proof of taxation? Who will assess the effective taxation?

Good news for the tax advisor, as can be seen now in the U.S., where modelling became a new business and prices for certain tax advice rose after tax reform. Bad news for M.N.E.'s that are subject to compliance regulations everywhere and struggling to concentrate on their business.

From a tax justice perspective, the proposals seem reasonable and may ease some pressure on governments. It makes sense to take out aggressive structuring with such measures. It is doubtful, however, that there will be much of a financial impact after M.N.E.'s restructure their transactional and value chain models.

From an economic perspective, there are downsides. Not all countries would follow the G.I.L.T.I. approach and headquarters suffering as a result of the G.I.L.T.I. provision may be interested in relocating to countries without controlled foreign corporation ("C.F.C.") rules. A deduction barrier, on the other hand, is nothing more than a tariff on intangibles. The world seems to have forgotten the value of free trade.

PART THREE – WHAT ABOUT B.E.A.T.?

The O.E.C.D. paper does not address B.E.A.T. Neither did it exist in U.S. tax reform plans until it was introduced one week before the tax reform was enacted. Nevertheless, it is important to keep in mind. The B.E.A.T. is easy to implement and leads to effective double taxation that most likely cannot be resolved.

The danger is that this easy solution for tax administrations leaves all problems with the taxpayer. B.E.A.T. is easy to implement and easy to calculate. It brings "justice" to administrations fighting base erosion. It has a limited risk of facing mutual arbitration between countries or other countries wanting to participate in taxing home country profits. All in all, this approach only leads to additional tax revenues with no downsides for the tax administration. For taxpayers facing double taxation, the problems abound.

CONCLUSION

Part one is a dinosaur from 2013 in a world where much has changed. Tax reform in the U.S. brought the country some relief from a justice viewpoint. European governments hopefully realize that such approaches fall back on them.

Regrettably, part two is relatively likely to be enacted. Germany has already enacted a license deduction barrier and the Finance Minister expressed his approval of the G.I.L.T.I. approach. One can envision the crazy world that will arise when countries enact G.I.L.T.I. rules and deduction barriers at the same time. An entire article could be devoted to a deduction barrier case for a subsidiary that makes payments to another M.N.E. subject to two G.I.L.T.I. regimes and applies the U.S. tax on foreign-derived intangible income ("F.D.I.I.") plus immediate depreciation in the context of group taxation.

Finally, one should not rule out the silent part three. Although not on the official agenda, M.N.E.'s can expect to be beaten by the B.E.A.T. in countries other than the U.S. When discussing the O.E.C.D. proposal, it might make sense to push for a G.I.L.T.I. or transactional deduction barrier approach in order to avoid the B.E.A.T. However, this form of taxation is a relatively logical consequence in cases where the O.E.C.D. project falls short of its taxation goals.

TAX AUTHORITIES EYE GSK-HUL MERGER: COULD ATTRACT TAX ON LONG-TERM CAPITAL GAINS AND BRAND TRANSFER[1]

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GSK Consumer Healthcare India ("GSK India") is in the process of merging with Hindustan Unilever Ltd ("HUL") in the biggest deal in India's consumer packaged goods space. The proposed all-stock deal values GSK India at around I.N.R. 31,700 crore,[2] or close to U.S. $4.5 billion. Each shareholder of GSK India is likely to get 4.39 shares of HUL per share.

Given the size of the deal, the Indian income tax authorities have already begun dissecting its structure and mechanics to identify or assess any tax obligations resulting from the proposed merger.

STOCK ACQUISITION

While the merger may be "tax neutral" (subject to the fulfillment of prescribed conditions under the Income Tax Act, 1961), the shareholders of GSK India who will receive shares of HUL after the merger may be exposed to a 10% long-term capital gains tax upon a subsequent sale of the HUL shares received in the merger. This tax outcome must be taken into account.

This is, effectively, how mergers are taxed: exemption at the merger stage and subsequent taxation when shareholders subsequently sell the shares they receive.

BRAND TRANSFER

Apart from the stock, the deal also entails an offshore transfer of the Horlicks brand from GSK India's foreign shareholder, GSK PLC, to Unilever PLC, HUL's foreign shareholder.

The Indian tax treatment of the transfer of a brand between two foreign companies is a contentious tax issue in India, and the tax exposure likely will depend primarily on the situs of the brand and related aspects.

According to §9 of the Indian Income Tax Act, 1961, all income accruing or arising, directly or indirectly, through the transfer of a capital asset (*e.g.*, brands and trademarks) situated in India is deemed to accrue or arise (*i.e.*, to be earned) in India for tax purposes.

In the case of *CUB PTY Ltd. (formerly known as Foster's Australia Ltd) v. Union of India*, the ruling of the Delhi High Court supports the idea that if the owner of a

1 This article first appeared on Moneycontrol.com.

2 In India, the term crore is used as a shortcut reference to 10 million. Thus, I.N.R. 31,700 crore equals I.N.R. 317 billion.

brand is not located in India, its situs should be regarded as outside India. Thus, the transfer of the brand should not be taxable in India.

However, since most of the value for the Horlicks brand is derived from India, the Indian tax authorities may take a position that the value of the brand is primarily derived from India. If this position is raised and successfully maintained by the Indian tax authorities, all or most of the gain realized from the transfer would be taxable in India. As in all tax controversies, much depends on the facts of the case.

However, given the value of the deal will lead to the creation of goodwill in HUL's books, HUL may be able to mitigate its tax outcome in the subsequent years by amortizing that goodwill on a year-over-year basis. Having said this, "allowability of depreciation" (which is a tax-deductible expense) is often looked at differently by taxpayers and tax authorities. While there are judgments to support HUL's possible claim for depreciation deductions, the tax authorities likely would dispute the claim, if history holds true. Should HUL succeed in a claim for depreciation, it would be an added advantage for the company.

It is anticipated that royalties will be paid by HUL for the use of the brand. This will contribute to additional tax controversy. In principle, the royalty will be deductible, but the amount of the deduction is a factual issue, ripe for controversy. The amount of the deduction is capped by arm's length concepts. Here, views typically differ between that authorities and taxpayers. To some extent, it is mitigated, as the amount paid under the license agreement would be taxable in India and subject to withholding tax obligations for HUL.

CONCLUSION

India's M&A sector has been picking up swiftly this year, allowing shareholders to unlock value with billion-dollar deals like Flipkart-Walmart, and now GSK-HUL. Companies and shareholders are looking for more operational synergies and strategic acquisitions, and they are willing to pay big-ticket prices for them.

One hopes that the parties involved will carefully examine and evaluate the income tax aspects of these deals, as any exposure on the income tax front can impact the deal dynamics. The Indian tax authorities have already begun to scrutinize the HUL-GSK India deal, and only time will tell whether it will be smooth sailing on that front.

PROPOSED CODE §864(C)(8) REGULATIONS CODIFY TAX ON GAIN FROM SALE OF PARTNERSHIP INTEREST

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Tags
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Sale

INTRODUCTION

Code §864(c)(8) was enacted on December 22, 2017, by Public Law 115-97 ("P.L. 115-97"). P.L. 115-97 also added new Code §1446(f). Both provisions are interrelated and address the treatment of a foreign partner's gain on the sale of a U.S. partnership interest.

Code §864(c)(8) was enacted to codify the holdings of Rev. Rul. 91-32[1] and overturn the result of the *Grecian Magnesite* case.[2] Code §864(c)(8) provides that gains or losses realized upon the direct or indirect disposition of a U.S. partnership interest by a non-U.S. partner generally constitute effectively connected income ("E.C.I.") to the extent that a fair-market-value sale of all the partnership assets would have generated effectively connected gain or loss in the hands of the transferor partner. Absent this characterization as E.C.I., gain (other than gain attributable to U.S. real estate) realized by nonresident individuals or non-U.S. corporations would not be taxable in the U.S.[3]

As a general rule, Code §1446(f) provides that if any gain on the disposition of a partnership interest is treated as E.C.I. pursuant to Code §864(c)(8), the transferee must withhold 10% of the amount realized on the sale. The amount realized includes not only payments made by the purchaser but also the amount of the seller's distributive share of partnership debt, which ordinarily provides the selling partner with a basis in the partnership interest at the time of acquisition or refinance. When that share of debt is eliminated as a result of the sale, the partner is considered to realize additional amounts in the sale. This can result in the withholding of 100% of the sales proceeds when non-recourse liabilities are involved.

On April 2, 2018, the I.R.S. published Notice 2018-29 (the "Notice"), describing Treasury Regulations it intended to issue with regard to the new withholding requirement on transfers of partnership interests by non-U.S. partners.[4]

On December 20, 2018, the U.S. Treasury Department and the I.R.S. released proposed regulations containing guidance under new Code §864(c)(8).[5] The preamble to the proposed regulations states that while the proposed regulations issue no

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1 Rev. Rul. 91-32, 1991-1 C.B. 107.

2 *Grecian Magnesite Mining v. Commr.*, 149 T.C. No. 3, 2017; see "Foreign Partner not Subject to U.S. Tax on Gain from Redemption of U.S. Partnership Interest," *Insights* 5, no. 8 (August 2017).

3 *Id.*; Code §§871, 881.

4 "Foreign Investor in a U.S. L.L.C. – How to Minimize Withholding Tax on Sale of L.L.C. Interest," *Insights* 5, no. 5 (June 2018).

5 REG-113604-18.

Code §1446(f) guidance, the Treasury Department and the I.R.S. intend to issue such guidance "expeditiously."

The proposed regulations address the following:

- Rules to compute the amount of gain or loss that must be treated as E.C.I. under Code §864(c)(8), including (i) the determination of gain and loss as ordinary or capital, (ii) the fact that only realized gain and loss are to be taken into account, (iii) sourcing rules, (iv) the definition of "non-separately stated taxable income or loss of the partnership," and (v) the interaction with the Code §751 "hot assets" rules
- Coordination of Code §864(c)(8) with Code §897
- Coordination of Code §864(c)(8) with U.S. income tax treaties
- Anti-abuse rules

"The foreign partner is required to first determine the amount of gain or loss on the transfer and then determine the partner's share of E.C.I. that it would have recognized if the partnership sold all of its assets immediately before the transfer."

Further, the proposed regulations provide that when both Code §864(c)(8) and another Code section apply, and the taxable E.C.I. amount is greater under the provisions of the other Code section, the larger amount is treated as E.C.I.[6]

The proposed regulations generally apply to transfers occurring on or after November 27, 2017. However, to the extent any provision is finalized after June 22, 2019, it is expected to apply only to transfers occurring on or after December 26, 2018.

COMPUTATION OF E.C.I. GAIN OR LOSS

A non-U.S. individual or corporation holding a direct or indirect interest in a U.S. partnership that is engaged in a U.S. trade or business must generally treat any gain or loss recognized on the sale or exchange of such partnership interest as E.C.I.[7] This recognition of gain or loss as E.C.I. is limited by the amount determined under Code §864(c)(8)(B).

The foreign partner is required to first determine the amount of gain or loss on the transfer (the "Outside Gain or Loss") and then determine the partner's share of E.C.I. that it would have recognized if the partnership sold all of its assets immediately before the transfer. The amount of E.C.I. on the transfer will be the lesser of (i) the foreign partner's Outside Gain or Loss and (ii) the foreign partner's deemed share of E.C.I. at the time of the transfer.

Step 1: Characterization of Outside Gain or Loss on Sale or Exchange

Source of Gain or Loss on Sale or Exchange

By generally characterizing the sale or exchange of a partnership interest as E.C.I., Code §864(c)(8), with important limitations, is essentially overriding the Code §864(c)(4) sourcing rules that generally prevent non-U.S.-source income from being treated as E.C.I. As a result, and as explained by the preamble to the proposed regulations:

6 Prop. Treas. Reg. §1.864(c)(8)-1(b)(1).

7 Code §864(c)(8)(A).

> Gain or loss recognized on the transfer of an interest in a partnership that is engaged in a trade or business within the United States may be treated as effectively connected gain or loss even if it is from sources without the United States.

Presumably, a partner will be entitled to the benefit of foreign tax credits for foreign income taxes paid on the sale or exchange to the extent E.C.I. would be characterized as non-U.S.-source.

Ordinary v. Capital Gain Characterization

The actual first step in determining a partner's Code §864(c)(8) gain is to determine the character of the partner's Outside Gain or Loss. This determination is made under all relevant provisions of the Code. Thus, Outside Gain or Loss can be capital ("Outside Capital Gain or Loss") or ordinary ("Outside Ordinary Gain or Loss").

As explained in further detail below, Code §864(c)(8) must be applied separately with regard to a partner's Outside Capital Gain or Loss and Outside Ordinary Gain or Loss. More specifically, a non-U.S. partner must determine its Outside Gain or Loss under Code §741 (capital) and Code §751 (ordinary).[8] This effectively results in a non-U.S. partner having two maximum amounts of potential E.C.I.:

- Outside Capital Gain or Loss under Code §741
- Outside Ordinary Gain or Loss under Code §751

Further, the proposed regulations specifically state that only gain or loss otherwise recognized under the Code is taken into account in computing a partner's Outside Gain or Loss. Thus, gain or loss that would otherwise be subject to nonrecognition provisions is not included.

The I.R.S. and the Treasury continue to consider, and request comments on, distributions such as certain Code §731 distributions of property to non-U.S. partners (instead of U.S. partners) that would result in no gain or loss recognized under Code §871 and Code §881.

Step 2: Code §864(c)(8)(B) Limitation to Outside Gain or Loss Treated as E.C.I.

Once determined, a partner's Outside Gain or Loss is compared to the Code §864(c)(8)(B) limitation. To arrive at this limitation, three amounts must first be determined:

- **Amount A.** This is the amount of gain or loss that the partnership would recognize in a fully taxable transaction with respect to each of its assets were it to sell each asset in a cash transaction at fair market value to an unrelated third party immediately prior to the partner's transfer of the partnership interest.[9]
- **Amount B.** This is the portion of Amount A that would be treated as effectively connected gain or loss ("Deemed Sale E.C. Gain or Loss").[10] The principles of Code §864 and the regulations thereunder apply to determine what part

[8] Prop. Treas. Reg. §1.864(c)(8)-1(b)(2)(i).

[9] Prop. Treas. Reg. §1.864(c)(8)-1(c)(1).

[10] Prop. Treas. Reg. §1.864(c)(8)-1(c)(2).

would be treated as E.C.I. See below for more details as to the determination of Amount B.

- **Amount C.** This is the non-U.S. partner's distributive share of the ordinary and capital components of any Deemed Sale E.C. Gain or Loss (respectively, "Deemed Sale E.C. Ordinary Gain or Loss" and "Deemed Sale E.C. Capital Gain or Loss"). See below for more details as to the determination of Amount C.

The partner's Outside Ordinary Gain or Loss is then compared to that partner's Deemed Sale E.C. Ordinary Gain or Loss. Gains are applied towards gains, and losses are applied towards losses. The Outside Ordinary Gain or Loss constitutes E.C.I. only to the extent it does not exceed the Deemed Sale E.C. Ordinary Gain or Loss.

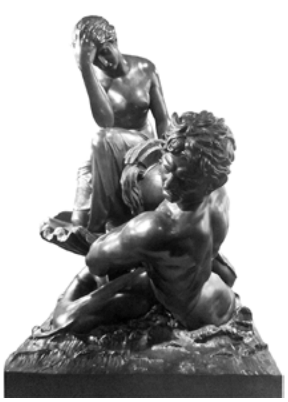
Similarly, a partner's Outside Capital Gain or Loss is compared to the partner's Deemed Sale E.C. Capital Gain or Loss. Here again, (i) gains are applied towards gains and losses towards losses, and (ii) the Outside Capital Gain or Loss constitutes E.C.I. only to the extent it does not exceed the Deemed Sale E.C. Capital Gain or Loss.

Determination of Amount B and Applicable Sourcing Rules

In determining Amount B, one must first determine whether the gain or loss would be from a U.S. source. Only to such extent can the gain or loss then be characterized as E.C.I. The determination is factual, and the proposed regulations provide that all gain or loss is U.S.-source, as if the partnership maintains an office or other fixed place of business in the U.S.[11] Since this rule could convert gain and loss from assets that have no connection with the partnership's U.S. trade or business into E.C.I., the proposed regulations provide a safe harbor rule. The gain or loss will not be U.S.-source if the following conditions are met:[12]

- The asset produced no E.C.I. nor effectively connected gain during the ten-year period ending on the date of the transfer.
- The asset was not used, or held for use, in the conduct of a U.S. trade or business during that ten-year period.

Determination of Amount C



A partner's distributive share of gain or loss on the deemed sale is determined in the same manner as the partner's distributive share of the "non-separately stated taxable income or loss of the partnership."[13] This term is not defined anywhere.

The proposed regulations provide that the distributive share must be determined under all applicable Code sections. This includes the special allocation and basis rules described in Code §704, Code §704(c), and Code §743 so as to take into

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[11] *Id.* The proposed regulations are not entirely clear on the treatment of a case where the taxpayer has no office or other fixed place of business in the U.S. Some commentators believe that U.S. taxation would occur even under these circumstances.

[12] Prop. Treas. Reg. §1.864(c)(8)-1(c)(2)(ii).

[13] Code §864(c)(8)(B), last para.

account the economic agreement among the partners and most closely reflect the tax consequences to the partners of an actual sale of the partnership assets.

The I.R.S. and the Treasury are considering whether anti-abuse provisions are necessary in order to avoid allocations of effectively connected gain or loss to specific partners in order to avoid the provisions of Code §864(c)(8).

F.I.R.P.T.A. AND CODE §864(C)(8) E.C.I.

Code §864(c)(8)(C) provides that any F.I.R.P.T.A. gain should decrease the Code §864(c)(8)(A) E.C.I. amount. However, the proposed regulations provide that when a partnership holds a U.S. real property interest and the partnership is otherwise engaged in a U.S. trade or business, the entire amount of the non-US. partner's E.C.I. is subject to Code §864(c)(8) and not to F.I.R.P.T.A.

While this may, in the long term, facilitate the computation of E.C.I. in this fact pattern, it has adverse tax consequences in the short term, pending favorable Code §4116(f) regulations. Indeed, no withholding certificates similar to the ones allowable under F.I.R.P.T.A. can be filed under Code §1446(f).

INTERACTION WITH TREATY PROVISIONS

For purposes of applying U.S. income tax treaty provisions, a sale or exchange of a partnership interest by a non-U.S. transferor is generally treated as a sale of a permanent establishment or the sale of the assets of a permanent establishment under the gains article of the applicable treaty, provided that the partnership has a permanent establishment.[14] A foreign transferor's distributive share of Deemed Sale E.C. Gain or Loss is determined with respect to the assets of the partnership that form part of the permanent establishment to the extent not otherwise exempt from U.S. taxation under the treaty.

As a result, even with the application of a treaty, the provisions of Code §864(c)(8) should apply to the sale or exchange of a partnership interest by a non-U.S. partner operating through a U.S. permanent establishment, unless the treaty exempts certain items.

ANTI-ABUSE RULE

The proposed regulations provide that any transfer by a non-U.S. transferor of property, including a partnership interest, to a partnership with the principal purpose of reducing the amount of E.C.I. under Code §864(c)(8) or Code §897 will be disregarded or recharacterized in accordance with its substance.

CONCLUSION

While the proposed regulations clarify the actual application of Code §864(c)(8), no clear and complete regime is available until the issuance of proposed regulations under Code §1446(f).

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[14] Prop. Treas. Reg. §1.864(c)(8)-1(f).

PROPOSED AMENDMENTS TO F.A.T.C.A. SUGGEST REDUCING OR DEFERRING WITHHOLDING

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Tags
F.A.T.C.A.
Foreign Passthru Payment
F.F.I.
Investment Entity
Withholding

On December 13, 2018, the I.R.S. issued proposed regulations under Code §§1471 through 1474 (F.A.T.C.A provisions) as well as under Code §§1441 and 1461 (withholding on non-U.S. persons and withholding agent liability for under-withholding, respectively). The proposed regulations are the result of an I.R.S. review of existing regulations and public comments received in response to President Trump's executive order requiring Federal government agencies to review existing regulations with the goal of modifying or eliminating regulations to reduce unnecessary burdens.

This F.A.T.C.A. update will focus on the proposed regulations under F.A.T.C.A. The proposed regulations would eliminate F.A.T.C.A. withholding on gross proceeds, defer F.A.T.C.A. withholding on Passthru Payments, eliminate withholding on certain insurance premiums, and clarify the definition of an investment entity, a subcategory of a foreign financial institution ("F.F.I."). The Preamble to proposed regulations explains that the significant relief from potential withholding and compliance burdens is possible thanks to the wide network of intergovernmental agreements ("I.G.A.'s") that the U.S. engaged in, and which facilitates international F.A.T.C.A. compliance.

WITHHOLDING ELIMINATED ON PAYMENTS OF GROSS PROCEEDS

F.A.T.C.A. imposes withholding on "withholdable payments" made to certain F.F.I.'s and certain non-financial foreign financial entities ("N.F.F.E.'s"). Withholdable payments were defined in the Code:

- Any of the following U.S.-source payments: interest, including original issue discount ("O.I.D."); dividends; rents; salaries; wages; premiums; annuities; compensations; remunerations; emoluments; and other fixed or determinable, annual or periodical ("F.D.A.P.") gains, profits, and income
- Any gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends

Withholding on gross proceeds would have imposed a great burden on withholding agents. Therefore, the I.R.S. issued guidance deferring the date when withholding would begin, with the latest guidance deferring withholding until January 1, 2019. The preamble to the proposed regulations explains that with 87 jurisdictions having an I.G.A. (intergovernmental agreement) in force and another 26 jurisdictions having I.G.A.'s signed or agreed in substance, international cooperation to facilitate F.A.T.C.A. implementation is sufficient. Current withholding serves as a significant deterrent for noncompliance, and as a result, it is not necessary to impose the burdens of gross proceeds withholding, which can be eliminated. This change will result in only U.S.-source F.D.A.P. that is withholdable under the definition, and not otherwise exempt, being subject to F.A.T.C.A. withholding.

WITHHOLDING DEFERRED ON FOREIGN PASSTHRU PAYMENTS

F.A.T.C.A requires an F.F.I. to withhold on any "Passthru Payment" made to (i) any account holder that does not comply with the self-certification requirements (a "Recalcitrant Account") and (ii) any account holder that is a nonparticipating F.F.I. The Code defines a Passthru Payment as any withholdable payment or a payment attributable to a withholdable payment (referring to it as a Foreign Passthru Payment).

The I.R.S. proposed a framework for F.F.I.'s to determine whether payments are attributable to withholdable payments; however, it was viewed to be complex and to impose significant burdens and thus was not incorporated in the final F.A.T.C.A. regulations published in 2013. The regulations provided that withholding on Passthru Payments will not begin before the later of January 1, 2019, or the date the final regulations defining Foreign Passthru Payment are published. In recognition of the time necessary to implement a system for withholding on Foreign Passthru Payments and successful engagement in a significant number of I.G.A.'s, the I.R.S. proposed to further delay the implementation of withholding on Foreign Passthru Payments.

The I.R.S. is reluctant to eliminate this withholding, as it provides a way for a participating F.F.I. to continue to remain in compliance even when some account holders are noncompliant and, more importantly, it prevents nonparticipating F.F.I.'s from avoiding F.A.T.C.A. by investing in the U.S. through a participating F.F.I. "blocker." Therefore, the proposed regulations defer the obligation to withhold on Passthru Payments until two years after the date of publication of final regulations defining Foreign Passthru Payment.

INVESTMENT ENTITY CLARIFICATION

The definition of an F.F.I. includes Investment Entities. Under the regulations, an Investment Entity is one of the following:

- Any entity that primarily conducts as a business one or more of the following activities or operations for or on behalf of a customer:
  - trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures;
  - individual or collective portfolio management; or
  - otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons
- Any entity whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets that is "managed by" another entity that is a depository institution, custodial institution, insurance company, or an Investment Entity described above.

- Any entity that functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.

The regulations provided examples to illustrate the “managed by” category of Investment Entities and those referred to entities that are managed by an F.F.I. by virtue of an F.F.I. having discretionary authority to manage the entity’s assets. As a result, it was unclear whether an entity that meets the gross income requirement and that invests in a mutual fund could be viewed as an Investment Entity itself due to the mutual fund’s discretionary authority over the entity’s assets. However, the preamble to the proposed regulations confirms that the examples in the regulations were intended to cover entities that receive professional management advice that is tailored to the investment needs of the entity. They were not intended to cover entities that invest in a widely-held fund that employs a predetermined investment strategy. Thus, the proposed regulations clarify that an entity is not “managed by” an F.F.I. solely because the entity invests all or a portion of its assets in a mutual fund, an exchange traded fund, or a collective investment entity that is widely held and is subject to investor-protection regulation.

In contrast, an investor in a “discretionary mandate” is managed by the F.F.I. providing this investment product. A discretionary mandate is an investment product where the F.F.I. manages and invests the client’s funds directly in accordance with the client’s investment goals (rather than the client investing in a mutual fund, for example).

PERMANENT RESIDENCE SUBJECT TO HOLD MAIL INSTRUCTIONS

Current regulations allow an address to be treated as a permanent residence address despite being subject to a hold mail instruction when a person provides documentary evidence establishing residence in the country in which the person claims to be a resident for tax purposes. In response to comments that noted that establishing residence in a particular country is unnecessary when the person is not claiming treaty benefits, the proposed regulations clarify that the documentary evidence required is that which will support the person’s claim of foreign status. When a person claiming treaty benefits provides an address subject to a hold mail instruction, the person must provide evidence to support the person’s residency in that country. Additionally, the proposed regulations clarify that a hold mail instruction does not include a request to receive all correspondence electronically.

FINAL NOTES

Despite the latest report by the Treasury Inspector General for Tax Administration (“T.I.G.T.A.”), which concluded that after spending nearly $380 million the I.R.S. is still not prepared to enforce F.A.T.C.A. compliance, F.A.T.C.A. is here to stay. This is evident in the recent LB&I campaign that attacks entities that have F.A.T.C.A. reporting obligations but do not meet all their compliance responsibilities, as well as by these proposed regulations, which offer some relief for taxpayers and aim to enhance F.A.T.C.A. compliance.

WHO'S GOT THE B.E.A.T.? A PLAYBOOK FOR DETERMINING APPLICABLE TAXPAYERS AND PAYMENTS

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Tags
Base Erosion
B.E.A.T.
T.C.J.A.

INTRODUCTION

Code §59A was enacted to impose tax on U.S. corporations with substantial gross receipts when base erosion payments to related entities significantly reduced regular corporate income tax imposed at a 21% rate. The tax is known as the base erosion and anti-abuse tax (the "B.E.A.T."). In late December, the I.R.S. proposed regulations that will provide guidance for affected taxpayers.

This article is the first in a series that will explain how the proposed regulations identify the taxpayers affected by the B.E.A.T. and the ways those taxpayer will be affected.

APPLICABLE TAXPAYERS

According to Prop. Treas. Reg. §1.59A-2, the B.E.A.T. applies only to a corporation, other than a R.I.C., R.E.I.T., or S-corporation, that satisfies the gross receipts test and the base erosion percentage test. For this purpose, related corporations within a "controlled group," per Code §52(a), generally are treated as a single taxpayer. The controlled group includes domestic and foreign corporations. For the latter, only gross receipts that generate effectively connected income ("E.C.I.") subject to tax under Code §882(a) are taken into account.

The Aggregate Group Concept

The regulations use the term "Aggregate Group" to refer to members within the controlled group that are taken into account as part of a single taxpayer.

The proposed regulations limit the Aggregate Group to corporations that benefit from deductions – and for that reason may have base erosion tax benefits. They exclude foreign corporations that are not subject to net U.S. income tax. Thus, foreign corporations that generate U.S.-source income taxable under Code §881 on a gross basis, only, are excluded. If a foreign corporation has both E.C.I. taxed under Code §882 and fixed and determinable annual and periodic income taxed under Code §881, only the former is included. If a foreign corporation determines its net taxable income under an applicable income tax treaty, so that part of its E.C.I. is not attributable to a permanent establishment in the U.S. and therefore not taxed, the foreign corporation is a member of the Aggregate Group only with regard to gross receipts attributable to the permanent establishment, which are taxed as business profits.

The proposed regulations generally provide that payments between members of the Aggregate Group are not included in the gross receipts of the Aggregate Group or in the numerator or the denominator used to calculate the base erosion percentage. This approach is consistent with the single entity concept of Code §59a(e)(3).

Payments between the Aggregate Group and any outside foreign corporation are taken into account in applying both the gross receipts test and the base erosion percentage test. On the other hand, payments to a foreign corporation from within the Aggregate Group that are subject to net income tax in the U.S. are not taken into account in applying the gross receipts test and the base erosion percentage test. It follows that one payment by a domestic corporation to a foreign corporation may not be taken into account in determining whether an Aggregate Group is an applicable taxpayer, while another payment between the same parties is taken into account.

"One payment by a domestic corporation to a foreign corporation may not be taken into account in determining whether an Aggregate Group is an applicable taxpayer, while another payment between the same parties is taken into account."

The I.R.S. has requested comments on the proposed Aggregate Group concept.

Gross Receipts Test

A taxpayer satisfies the gross receipts test if the taxpayer or the Aggregate Group has $500 million or more of average annual gross receipts during the three prior taxable years. In the case of a foreign corporation, gross receipts are taken into account only if subject to net income tax under both U.S. domestic law and an applicable income tax treaty.

The taxpayer's Aggregate Group is determined as of the end of its taxable year for which B.E.A.T. liability is being computed, and the calculation includes the gross receipts of those Aggregate Group members during the prior three-year period. The proposed regulations include specific rules for corporations that have been in existence for fewer than three years or have short years. The rules are generally consistent with Code §§448(c)(3)(B) through (D). The proposed regulations also clarify how gross receipts are determined when members of the Aggregate Group have differing taxable years.

In addition, if a member of an Aggregate Group owns an interest in a partnership, the proposed regulations provide that the group must include the member's distributive share of items of gross income from the partnership.

Base Erosion Percentage Test

The base erosion percentage for a taxable year is computed by dividing (i) the aggregate amount of base erosion tax benefits (the "numerator") by (ii) the sum of the aggregate amount of deductions plus certain other base erosion tax benefits (the "denominator"). The B.E.A.T. applies only when the numerator exceeds 3% of the denominator – or 2% if the applicable taxpayer or a member of its Aggregate Group is a domestic bank or registered securities dealer.

The numerator of the base erosion percentage excludes deductions for the following:

- Amounts paid or accrued to foreign related parties for services qualifying for the services cost method ("S.C.M.") exception in Prop. Treas. Reg. §1.59A-3(b)(3)(i)
- Payments covered by the qualified derivatives payments ("Q.D.P.") exception in Prop. Treas. Reg. §1.59A-3(b)(3)(ii)
- Amounts excluded pursuant to the total loss-absorbing capacity ("T.L.A.C.") exception in Prop. Treas. Reg. §1.59A-3(b)(3)(v)[1]

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[1] The Federal Reserve requires that certain global systemically important banking organizations ("G.S.I.B.'s") issue T.L.A.C. securities as part of a global

In certain circumstances, an applicable taxpayer may make a payment to a foreign related party that is not a member of the Aggregate Group. This would occur if the recipient of the payment is a 25% owner[2] of the applicable taxpayer but does not own more than 50%. If that payment qualifies for the S.C.M., the Q.D.P., or the T.L.A.C. exception and is properly characterized as E.C.I.,[3] the payment will be included in the denominator of the fraction when computing the base erosion percentage. On the other hand, if the excluded payments are not properly treated as E.C.I., they are removed from the denominator of the fraction in addition to the numerator.

Code §988 addresses currency gains and losses derived in connection with certain debt obligations, accrued but unpaid expenses, and certain forward or futures transactions. Such losses are removed from the numerator and the denominator in determining the base erosion percentage.

The numerator of the base erosion percentage only takes into account base erosion tax benefits for which a deduction is allowed under the Code in the taxable year. Similarly, the denominator of the base erosion percentage takes into account only deductions allowed under the Code. Disallowed deductions are excluded. Therefore, since a deduction allowed under Code §965(c) to a U.S. Shareholder of a deferred foreign income corporation is not specifically excluded, that deduction is included in the denominator.

A base erosion tax benefit is not included in the numerator when the payment is subject to tax under Code §871 or Code §881 and 30% withholding tax has been collected and paid over to the I.R.S. If the payment is subject to a reduced rate of withholding tax under an income tax treaty, the actual payment is treated as two separate payments. One such deemed payment is treated as subject to 30% withholding. The other such payment is treated as fully exempt. To determine the taxable portion, the withholding tax rate under the applicable treaty is divided by the 20% rate provided by domestic law. As a result, if the withholding tax rate in the treaty is 10%, one-third of the total payment is deemed to be fully taxed (10% ÷ 30% = 33.33%). The remaining two-thirds of the payment is treated as fully exempt. This computation uses rules similar to those in Code §163(j)(5)(B), as in effect before the T.C.J.A.

The base erosion percentage also takes into account (i) certain premiums or other considerations paid to a foreign related party for reinsurance and (ii) amounts paid or accrued by the taxpayer to certain surrogate foreign corporations that result in a reduction in gross receipts for the taxpayer.

Taxpayers in an Aggregate Group with Different Taxable Years

A corporation is determined to be an applicable taxpayer based on the gross receipts and base erosion payments of each member of the Aggregate Group. However, each member must compute the Aggregate Group amount of gross receipts and base erosion payments based on its own taxable year and based on those corporations that are members of the Aggregate Group at the end of such taxable year.

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framework intended to minimize the risk of insolvency. A full discussion of the T.L.A.C. rules is beyond the scope of this article.

2 Prop. Treas. Reg. §1.59A-1(b)(17).

3 Prop. Treas. Reg. §1.59A-3(b)(3)(iii).

In general, the proposed regulations provide that each taxpayer determines its gross receipts and base erosion percentage by reference to its own taxable year, taking into account the results of other members of its Aggregate Group during that taxable year.[4] As a result, two related taxpayers with different taxable years will compute their applicable gross receipts and base erosion percentage by reference to different periods.

The fact pattern where this rule applies is broad. It can involve two or more separate chains of U.S. corporations in separate business segments where each chain separately files a consolidated tax return or brother-sister corporations having the same foreign corporation as a shareholder.

The following example illustrates the rule:

> **Facts.** The foreign parent ("F.P.") is a foreign corporation that owns all of the stock of a domestic corporation that uses a calendar year ("DC1") and a domestic corporation that uses a fiscal year ending on January 31 ("DC2"). F.P. does not have income effectively connected with the conduct of a trade or business within the U.S. DC2 is a member of DC1's Aggregate Group, and DC1 is a member of DC2's Aggregate Group.
>
> **Analysis.** For DC1's tax return for the calendar year ending December 31, 2026, DC1 determines its gross receipts based on the gross receipts of DC1 and DC2 for the calendar years ending December 31, 2023, December 31, 2024, and December 31, 2025. Further, DC1 determines its base erosion percentage for the calendar year ending December 31, 2026, on the basis of transactions of DC1 and DC2 for the calendar year ending December 31, 2026.
>
> For DC2's tax return for the fiscal year ending January 31, 2027, DC2 determines its gross receipts based on the gross receipts of DC2 and DC1 for the fiscal years ending January 31, 2024, January 31, 2025, and January 31, 2026. Further, DC2 determines its base erosion percentage for the fiscal year ending January 31, 2027, on the basis of transactions of DC2 and DC1 for the fiscal year ending January 31, 2027.[5]

When determining the base erosion percentage for a taxpayer in this fact pattern, the effective date for Code §59A applies by reference to the taxpayer making the return. Code §59A applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. Where one taxpayer reports on a calendar year basis and the other on a fiscal year basis ending on January 31, the calendar year taxpayer will take into account transactions of the fiscal year taxpayer beginning on January 1, whereas the fiscal year taxpayer takes into account transactions of the calendar year taxpayer beginning February 1.

B.E.A.T CALCULATIONS

Base Erosion Payments

The proposed regulations define a base erosion payment as a payment or accrual by the taxpayer to a foreign related party that falls into one of four categories:

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4 Prop. Treas. Reg. §1.59A-2(e)(3)(vii).

5 Prop. Treas. Reg. §1.59A-2(f)(2), example 2.

- A payment with respect to which a deduction is allowable
- A payment made in connection with the acquisition of depreciable or amortizable property
- A payment of premiums or other consideration for reinsurance that is taken into account under Code §§803(a)(1)(B) or 832(b)(4)(A)
- A payment that reduces the gross receipts of the taxpayer that is made with respect to certain surrogate foreign corporations or related foreign persons

Payments or Accruals that Consist of Non-Cash Consideration

A payment or accrual by a taxpayer may be a base erosion payment whether made in cash or in any form of non-cash consideration.[6] There may be situations where a taxpayer makes a non-cash transfer to a foreign related party. The transaction is subject to the B.E.A.T. as long as it meets one of the above definitions of a base erosion payment. It does not matter whether the transaction qualifies under certain nonrecognition provisions of the Code.[7]

Neither the nonrecognition of gain or loss to the transferor nor the absence of a step-up in basis to the transferee establishes a basis to exclude the payment from the definition of a base erosion payment. The statutory definition of base erosion payment is based on the amount of imported basis in the asset. In comparison, where a corporate taxpayer receives depreciable property from a foreign related party as an in-kind distribution subject to tax as a dividend under Code §301, there is no base erosion payment because there is no consideration provided by the taxpayer to the foreign related party in exchange for the property.

In addition, a base erosion payment also includes a payment to a foreign related party resulting in a recognized loss.

The proposed regulations do not include any specific exceptions for these types of transactions even though (i) the transferor of the assets acquired by the domestic corporation may not recognize gain or loss, (ii) the acquiring domestic corporation may take a carryover basis in the depreciable or amortizable assets, and (iii) the importation of depreciable or amortizable assets into the U.S. in these transactions may increase the regular income tax base as compared to the non-importation of those assets.

Interest Expense Allocable to a Foreign Corporation's E.C.I.

The B.E.A.T. applies to foreign corporations that have E.C.I., taking into account any applicable U.S. income tax treaty. A foreign corporation that has interest expense allocable under Code §882(c) to E.C.I. will have a base erosion payment to the extent the interest expense is paid to a foreign related party. The amount of interest that will be treated as a base erosion payment depends on the calculation method applied under Treas. Reg. §1.882-5.

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6 Prop. Treas. Reg. §1.59A-3(b)(2)(i).

7 Examples of such transactions include a domestic corporation's acquisition of depreciable assets from a foreign related party in an exchange described in Code §351, a liquidation described in Code §332, and a reorganization described in Code §368.

If a foreign corporation uses the method described in Treas. Reg. §§1.882-5(b) through (d), interest on direct allocations and on U.S.-booked liabilities paid or accrued to a foreign related party will be base erosion payments. If U.S.-booked liabilities exceed U.S.-connected liabilities, a foreign corporation computing its interest expense under this method must apply the scaling ratio to all of its interest expense on a *pro-rata* basis to determine the amount that is a base erosion payment. Interest on excess U.S.-connected liabilities also may be a base erosion payment if the foreign corporation has liabilities with a foreign related party.

Other Deductions Allowed with Respect to E.C.I.

Like excess interest expense, the proposed regulations provide that the amount of a foreign corporation's other deductions properly allocated and apportioned to effectively connected gross income under Treas. Reg. §1.882-4 are base erosion payments to the extent that those deductions are paid or accrued to a foreign related party. Accordingly, the regulations identify base erosion payments by tracing each item of deduction and determining whether the deduction arises from a payment to a foreign related party.

If a foreign corporation engaged in a trade or business within the U.S. acquires property of a character subject to the allowance for depreciation from a foreign related party, the amount paid or accrued by the taxpayer is a base erosion payment to the extent the property is used, or held for use, in the conduct of a trade or business within the U.S.

Income Tax Treaties

Certain U.S. income tax treaties provide alternative approaches for the allocation or attribution of business profits from an enterprise of one contracting state to its permanent establishment in the other contracting state on the basis of assets used, risks assumed, and functions performed by the permanent establishment. The use of a treaty-based expense allocation or attribution method does not, in and of itself, create legal obligations between the U.S. permanent establishment and the rest of the enterprise. Nonetheless, the proposed regulations recognize that treaty-based expense allocation or attribution income may arise from internal transactions (known as internal dealings). The proposed regulations require that these deductions be treated as base erosion payments.

In the first instance, the allocation and apportionment of expenses of the enterprise to the branch or permanent establishment is not itself a base erosion payment because the allocation represents a division of the expenses of the enterprise, rather than a payment between the branch or permanent establishment and the rest of the enterprise.

In the second instance, internal dealings are not mere divisions of enterprise expenses but rather are priced on the basis of assets used, risks assumed, and functions performed by the permanent establishment in a manner consistent with the arm's length principle.

The approach in the proposed regulations creates parity between deductions for (i) actual regarded payments between two separate corporations and (ii) internal dealings.

EXCLUDED PAYMENTS

Certain Services

The S.C.M. exception provides that Code §59A(d)(1) does not apply to any amount paid or accrued by a taxpayer for services if (i) the services are eligible for the services cost method under Code §482 and (ii) the amount constitutes the total services cost with no markup component. The I.R.S. interprets the key components as follows:

- The term "S.C.M." refers to the services cost method described in Treas. Reg. §1.482-9(b).
- The requirement regarding "fundamental risks of business success or failure" refers to the test in Treas. Reg. §1.482-9(b)(5), commonly called the business judgment rule.
- The term "total services cost" refers to the definition of "total services costs" in Treas. Reg. §1.482-9(j).

The preamble to the proposed regulations explains that Code §59A(d)(5) is ambiguous as to whether the S.C.M. exception applies when an amount paid for services exceeds the total services cost but the payment otherwise meets the other requirements for the S.C.M. exception. Under a literal interpretation, the S.C.M. exception does not apply to any portion of a payment that includes any mark-up component. Under another interpretation based on a set of legislative questions and answers known as a "soliloquy," the S.C.M. exception is available if there is a markup – but only to the extent of the total services costs. Under the latter approach, the services cost would continue to qualify for the S.C.M. exception provided the other requirements of the S.C.M. exception are met. The latter approach to the S.C.M. exception is more expansive because it does not limit qualification to payments made exactly at cost.

"The S.C.M. exception is available if there is a markup (and if other requirements are satisfied), but the portion of any payment that exceeds the total cost of services is not eligible."

The proposed regulations provide that the S.C.M. exception is available if there is a markup (and if other requirements are satisfied), but the portion of any payment that exceeds the total cost of services is not eligible for the S.C.M. exception and is a base erosion payment.

To be eligible for the S.C.M. exception, all of the requirements of Treas. Reg. §1.482-9(b) must be satisfied, except as modified in these regulations. Therefore, a taxpayer's determination that a service qualifies for the S.C.M. exception is subject to review under the requirements of Treas. Reg. §§1.482-9(b)(3) and (b)(4), and its determination of the amount of total services cost and allocation and apportionment of costs to a particular service is subject to review under the rules of Treas. Reg. §§1.482-9(j) and 1.482-9(k).

Although the proposed regulations do not require a taxpayer to maintain separate accounts to bifurcate the cost and markup components of its services charges to qualify for the S.C.M. exception, the proposed regulations do require that taxpayers maintain books and records adequate to permit verification of, among other things, the amount paid for services, the total services cost incurred by the renderer, and the allocation and apportionment of costs to services in accordance with Treas. Reg. §1.482-9(k).

Certain services are not eligible for the method due to the business judgment rule or for other reasons. Nonetheless, payments for those services are eligible for the S.C.M. exception.

The proposed regulations also clarify that the reference to the business judgment rule in the parenthetical, *i.e.*, "(determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)," causes the entire requirement set forth in Treas. Reg. §1.482-9(b)(5) to be disregarded solely for purposes of Code §59A(d)(5).

Qualified Derivative Payments

A Q.D.P. exception can apply to any payment made by a taxpayer to a foreign related party pursuant to a derivative for which the following is true:

- The taxpayer recognizes gain or loss on the derivative on a mark-to-market basis.
- The gain or loss is ordinary.
- Any gain, loss, income, or deduction is also treated as ordinary.

The Q.D.P. exception applies only if the taxpayer satisfies reporting requirements that appear in Prop. Treas. Reg. §1.6038A-2(b)(7)(ix). If a taxpayer satisfies the reporting requirements for some Q.D.P.'s, but not all, only the payments for which the taxpayer fails to satisfy the reporting requirements will be ineligible for the Q.D.P. exception. The reporting requirement will first apply to taxable years beginning after final regulations are published. Until then, taxpayers may satisfy the reporting requirements by reporting the aggregate amount of Q.D.P.'s on Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*.

Recipients Subject to U.S. Tax

For a payment to be treated as a base erosion payment, the recipient must be a foreign person. Code §6038A(c)(3) defines "foreign person" as any person that is not a U.S. person within the meaning of Code §7701(a)(30). However, for the B.E.A.T., the term "U.S. person" does not include any individual who is a citizen of any U.S. territory and is not otherwise a citizen or resident of the U.S.[8]

The proposed regulations include an exception from the definition of base erosion payment for amounts considered to be E.C.I.. If a foreign recipient determines its net taxable income under an applicable income tax treaty, the exception applies to payments that are considered to be business profits attributable to a permanent establishment or real property income, both of which are subject to net rates of tax under general treaty concepts.

Base Erosion Payments Occurring Before the Effective Date and Pre-2018 Disallowed Business Interest

As previously mentioned, the B.E.A.T. applies only to base erosion payments paid or accrued in taxable years beginning after December 31, 2017. Payments made prior to a taxable year beginning before January 1, 2018, are not subject to the B.E.A.T.

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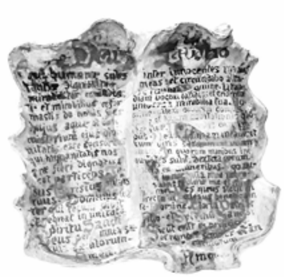
8 Prop. Treas. Reg. §1.59A-1(b)(10).

To illustrate, assume that in 2015, a calendar year taxpayer made a payment to a foreign related party to acquire depreciable property. The taxpayer's depreciation deduction allowed in 2018 with respect to this property is not a base erosion tax benefit. Similarly, if in 2016, a taxpayer with a calendar year accrued interest on an obligation to a foreign related party, but the interest was not until paid under Code §267(a), the taxpayer's payment of the interest in 2018 is not a base erosion tax benefit.

The proposed regulations reverse a position stated in Notice 2018-28 regarding interest expense for which a deduction was not allowed as a by reason of Code §163(j). The notice concluded that business interest carried forward from a taxable year beginning before January 1, 2018, would be treated in the same manner as interest paid or accrued in a taxable year beginning after December 31, 2017, for purposes of Code §59A. This position has been abandoned. Any deferred interest that is carried forward from a taxable year beginning before January 1, 2018, is not a base erosion payment.

CONCLUSION

Proposed regulations on the B.E.A.T. provide a road map for understanding the focus of the I.R.S. in implementing the tax. In a second installment, we will focus on more of the detail affecting certain expenses and certain industries.



UPDATES & OTHER TIDBITS

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Tags
China
Foreign Investment
Intellectual Property
Netherlands
State Aid

NEW FOREIGN INVESTMENT LAW COULD EASE U.S.-CHINA TRADE WAR

In an attempt to resolve the long-standing trade dispute between China and the U.S., China released a draft of its new foreign investment law. The changes are intended to replace the current law, which forces foreign investors to transfer their intellectual property ("I.P.") and technology in return for access to China's vast market. The Chinese parliament is expected to pass the law in March.

China can take punitive measures if it encounters discriminatory treatment on investment overseas, and foreign investment that could have an impact on national security would be subject to increased scrutiny.

The current Chinese foreign investment law requires foreign companies proposing to produce and sell goods in China to enter into joint ventures and disclose their I.P. and technology to Chinese partners. The U.S., on the other hand, does not impose any such reciprocal requirements. As a counter measure, the U.S. imposed a 10% tariff on $200 billion worth of Chinese imports in the last quarter of 2018. If the countries do not reach an agreement by March 1, 2019, the U.S. has threatened to raise that tariff to 25%.

EUROPEAN COMMISSION TO INVESTIGATE DUTCH TAX RULINGS FOR STATE AID VIOLATION

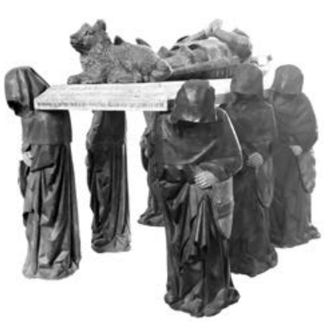
The European Commission ("E.C.") announced in early January that it will be investigating the tax rulings issued by Dutch tax authorities to two Nike group companies based in the Netherlands, Nike European Operations Netherlands BV ("Nike BV") and Converse Netherlands BV ("Converse BV"), to determine whether the rulings granted unfair advantages to Nike and Converse over other similar businesses and therefore violated E.U. State Aid rules.

Investigations into unfair advantages given to Starbucks have already been completed by the E.C. In 2015, the E.C. ruled that the Netherlands gave tax advantages to Starbucks, leading to a recovery of €25.7 million ($30 million). The E.C. is also looking into tax agreements between the Dutch government and Ikea.

Nike BV and Converse BV are engaged in the business of developing, marketing, and recording the sales of Nike and Converse products in Europe, the Middle East, and Africa. Nike BV and Converse BV licensed product-related intellectual property from two other Nike group companies to facilitate their businesses in the Middle East and Africa region. The recipients of the royalty income are transparent entities in the Netherlands and therefore do not pay any Dutch taxes. Nike BV and Converse BV, on the other hand, claim substantial deductions for royalty payments.

The five rulings (two of which are still in effect) issued by the Dutch tax authorities from 2006 to 2015 endorse a method to calculate the royalty payments. As a result of the rulings, Nike BV and Converse BV are only taxed in the Netherlands on a limited operating margin based on sales. The E.C. is concerned that the method of calculating the royalty does not reflect economic reality. The basis of this observation is that Nike BV and Converse BV have more than 1,000 employees and are actively engaged in business activities, while the two Nike group companies have no employees and do not carry out any economic activity.

The E.C. intends to determine whether (i) the Dutch tax rulings supporting these payments have unjustifiably reduced the Dutch taxable income of Nike BV and Converse BV and (ii) selective advantage has been granted to the Nike group by allowing it to pay less tax than similarly placed businesses whose transactions are priced at market rates. In the event that these criteria apply, it would amount to violation of E.U. State Aid rules.



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Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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