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In this installment of U.S. Tax Review, the authors review the Biden administration's international tax reform proposals, final regulations that modify subpart F and GILTI rules for consolidated groups, recent developments regarding the *Eaton* and *Bittner* cases, and IRS guidance on section 961 and sourcing.

Proposed International Tax Reforms

An undertaxed profits rule would replace the base erosion and antiabuse tax, the global intangible low-taxed income regime would be reformed, and the foreign-derived intangible income regime would be repealed under revenue proposals published by the Biden administration on March 9.

Some of the proposals in Treasury's fiscal 2024 green book are repeats from last year's green book,[1] and enacting them may be an even greater challenge than it was in 2022, when the Democratic Party had majorities in both the House of Representatives and the Senate. Replacing the BEAT with a UTPR was one of last year's proposals, and so were increasing the effective tax rate of the GILTI regime and repealing the GILTI exception for high-taxed income. Other proposals are from President Biden's first year in office, including eliminating the exclusion from the GILTI tax base of a 10 percent return on qualified business asset investment[2] and repeal of the FDII deduction.

New this year is a proposal to reduce the section 245A dividends received deduction. The deduction currently is 100 percent of the foreign-source dividends received by a U.S. shareholder that owns a 10 percent or greater interest in the foreign corporation. The Biden proposal would maintain that rule for dividends received from controlled foreign corporations but would reduce the deduction to 65 percent for foreign-source dividends received from other qualified foreign corporations if the U.S. shareholder owns at least 20 percent of the stock (by vote and value), and would reduce the deduction to 50 percent of the foreign-source dividends received from qualified foreign corporations in which the U.S. shareholder owns less than 20 percent of the stock. "Qualified foreign corporations" are defined as "corporations incorporated in a territorial

[1] *See* Larissa Neumann and Julia Ushakova-Stein, "U.S. Tax Review: Section 245A Regs, the Green Book, and Crypto Reporting," *Tax Notes Int'l*, May 2, 2022, p. 625.

[2] *See* James P. Fuller and Neumann, "U.S. Tax Review: The Biden Tax Plan, CFC Accounting Method Change, and *Amazon*," *Tax Notes Int'l*, June 7, 2021, p. 1315.

possession of the United States and certain corporations eligible for the benefits of a comprehensive income tax treaty." No dividends received deduction would apply to dividends received from foreign corporations that are not CFCs or qualified foreign corporations.

Not all proposals would increase taxes. The green book proposes reducing the haircut on GILTI-basket foreign tax credits from 20 percent to 5 percent. Nonetheless, the green book's international proposals represent a hefty tax increase; the Biden administration forecasts they would, on a net basis, generate an additional $1.16 trillion in taxes over the next 10 years. More than $1 trillion of that new revenue would come from reforms to the GILTI regime, tightening anti-inversion rules, and adopting a UTPR.

The GILTI deduction would drop from 50 percent to 25 percent, and the GILTI regime would apply jurisdiction-by-jurisdiction rather than worldwide, with section 904 limitations being applied separately for FTCs in each jurisdiction. U.S. shareholders would be able to carry forward their share of CFCs' net operating losses and foreign taxes, but the carryforwards would be jurisdiction-by-jurisdiction.

The reforms are intended to make the GILTI regime a so-called income inclusion rule for the purposes of pillar 2 of the international tax regime agreed to by the inclusive framework.

The anti-inversion proposal would stiffen section 7874 by replacing its 80 percent test with a 50 percent test. Currently, a foreign corporation that acquires substantially all the properties of a domestic corporation is generally taxed as a domestic corporation if more than 80 percent of the stock of the foreign corporation is held, after the transaction, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Under a new, second test, an inversion transaction would be treated as occurring if:

- immediately before the acquisition, the fair market value of the domestic entity is greater than the FMV of the foreign acquiring corporation;
- after the acquisition the expanded affiliated group is primarily managed and controlled in the United States; and
- the expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

An expanded affiliated group is, generally, a group of corporations that would be an affiliated group if affiliated groups could include foreign corporations and if members of affiliated groups could be connected by majority ownership rather than at least 80 percent ownership.

Final Regs Alter Subpart F, GILTI

Treasury and the IRS quickly finalized regulations (T.D. 9973) treating consolidated groups as a single shareholder when applying section 951(a)(2)(B) to distributions by a CFC of previously taxed earnings and profits (PTEP).

Under new reg. section 1.1502-80(j), proposed in December 2022[3] and finalized on February 23, members of a consolidated group are treated as a single shareholder for the purposes of determining the part of the year during which the shareholder did not own stock described in section 951(a)(2)(A).

The IRS stated that the regulations are intended to stop taxpayers from taking the position that an intercompany transfer of lower-tier CFC stock reduces the subpart F or GILTI inclusion of the consolidated group by the amount of distributions of PTEP made by the CFC during the tax year but before the intercompany transfer.

New reg. section 1.1502-80(j) is effective for consolidated federal income tax returns due (without regard to extensions) after February 23.

Eaton Controversies

Eaton Corp. argued in two recent U.S. Tax Court petitions that its court victories upholding advance pricing agreements should help it overcome IRS transfer pricing determinations for tax years after those APAs had expired.

In petitions filed March 3, with respect to the 2011 tax year and the 2012 and 2013 tax years, Eaton argues that IRS transfer pricing

[3] *See* Neumann and Ushakova-Stein, "U.S. Tax Review: Proposed Regs, Audit Disclosure, MAP Stats," *Tax Notes Int'l*, Jan. 2, 2023, p. 31.

adjustments are unlawful because Eaton "reasonably relied upon a transfer pricing method that had been agreed by the IRS" in the APAs, the first of which covered the 2001 through 2005 tax years and the second of which covered 2006 through 2010.

The Tax Court and the U.S. Court of Appeals for the Sixth Circuit upheld both APAs in *Eaton*.[4]

The IRS assessed Eaton a deficiency of $138,836,277 and $32,994,527 in penalties for 2011, a deficiency of $321,065,295 and $36,494,471 in penalties for 2012, and a deficiency of $289,283,526 and $40,211,513 in penalties for 2013. The disputes involve transfer pricing of intercompany transactions related to circuit breakers and electrical products, subpart F or section 956 inclusions, royalties for the use of intangible assets related to the manufacture of truck products, fees for intercompany guarantees, and interest rates for intercompany debt, among other things.

A domestic Eaton subsidiary distributed circuit breakers and electrical products in the United States that were manufactured by Eaton subsidiaries in Puerto Rico and the Dominican Republic. The domestic subsidiary also licensed intangible property to one of the manufacturing subsidiaries. The petitions assert that the transactions were materially identical to the transactions at issue in the prior Tax Court and Sixth Circuit case. Under a stipulated resolution to that case, entered February 3, the parties agreed to a total of less than $10 million in deficiencies for 2005 and 2006, which was less than one-twelfth of the total deficiencies and penalties the IRS originally sought.[5]

On the same day Eaton Corp. filed its petitions for 2011-2013, Eaton Controls (Luxembourg) SARL filed a petition challenging adjustments to the 2011 and 2012 dividend income of Eaton Worldwide LLC, a Delaware LLC owned by Eaton entities.[6] In its notices of final partnership administrative adjustment, the IRS applied various antiabuse provisions to either treat Eaton Worldwide as a foreign partnership or as an aggregate rather than an entity, and therefore not a U.S. shareholder for the purposes of the CFC tax regime.

Applying Non-Willful FBAR Penalties

The maximum penalty for a non-willful failure to report a financial interest in a foreign bank account is $10,000 per form, not per account, the Supreme Court held.

In *Bittner*,[7] the Court held that because 31 U.S.C. section 5314 covers only the duty to file the foreign bank account report and does not even use the word "account," the penalty imposed by 31 U.S.C. section 5321 for a violation of section 5314 must refer to a failure to file a report consistent with the statute's commands rather than a failure to report an interest in a specific account. Writing for a 5-4 majority, Justice Neil M. Gorsuch explained that although section 5321 refers to penalties for a willful "failure to report the existence of an account or any identifying information required to be provided with respect to an account," and such penalties for willful violations can be 50 percent of "the balance in the account at the time of the violation," the penalties for non-willful violations are not described on an account-by-account basis. Furthermore, although relief from the penalties under the reasonable cause exception requires that a report be accurate with respect to each account, "Congress did not say . . . that the government may impose non-willful penalties on a per-account basis."

Bittner resolved a split between the Fifth Circuit, which was reversed in *Bittner*, and the Ninth Circuit, which adopted the per-form reading in *Boyd*.[8] The Fourth Circuit had suggested, but not held, that it would take a per-form view.[9]

[4]*Eaton Corp. v. Commissioner*, T.C. Memo. 2017-147, *aff'd in part and rev'd in part*, 47 F.4th 434 (6th Cir. 2022). For prior coverage of the Tax Court's *Eaton* decision, see Fuller and Neumann, "U.S. Tax Review," *Tax Notes Int'l*, Aug. 7, 2017, p. 571. For prior coverage of the Sixth Circuit's *Eaton* decision, see Neumann and Ushakova-Stein, "U.S. Tax Review: *Eaton*, *Zehnder*, *Caterpillar*; PFIC, BEAT, and Other Priority Guidance," *Tax Notes Int'l*, Oct. 3, 2022, p. 31.

[5]For prior coverage of the stipulated resolution, see Neumann, Ushakova-Stein, and Mike Knobler, "U.S. Tax Review: *3M*, *Microsoft*, and *Eaton*; Dual Consolidated Loss Rules; Pillars 1 and 2," *Tax Notes Int'l*, Mar. 6, 2023, p. 1223.

[6]*Eaton Worldwide LLC et al. v. Commissioner*, No. 2606-23 (2023).

[7]*Alexandru Bittner v. United States*, 143 S. Ct. 713 (2023).

[8]*United States v. Boyd*, 991 F.3d 1077, 1079 (9th Cir. 2021).

[9]*See* Fuller, Neumann, and Ushakova-Stein, "U.S. Tax Review: *Whirlpool*, *Coca-Cola*, FTC Regs, DST Agreements, and Global Tax Reform," *Tax Notes Int'l*, Jan. 3, 2022, p. 21.

Section 961 IRS Guidance

Additional guidance released on March 10 reinforces the message that the IRS is adopting a taxpayer-favorable approach to resolving the long-standing regulatory mismatch between the timing of positive and negative basis adjustments under section 961. Although not precedential, AM 2023-002 follows the reasoning of LTR 202304008, which was recently released, in concluding that the positive basis adjustment from a GILTI inclusion should be taken into account before the negative basis adjustment from a mid-year distribution by a CFC.[10] IRS officials have informally stated that this can be taken as an indication of how future PTEP regulations will address the issue.

Under the facts of the memo, a domestic parent C corporation, USP, wholly owns a foreign corporation, FS, that is a CFC. Each of USP and FS is a calendar-year taxpayer. Before the relevant year, USP's adjusted basis in its stock of FS and USP's section 959 PTEP accounts for FS were both $0. FS had $10x of subpart F income, which USP included in its gross income under section 951(a)(1)(A). USP also included in its gross income under section 951A(a) its GILTI inclusion amount of $90x, all of which is allocated to FS. USP increased its PTEP accounts for FS by $100x ($10x + $90x) as "Year 1 Inclusions." On June 30 in Year 1, FS distributed $100 to USP (the "midyear distribution").

Under section 961(a) and reg. section 1.961-1(a), a U.S. shareholder's adjusted basis of CFC stock is increased by the amount required to be included in gross income under section 951(a) with respect to such stock. Section 951A(f)(1) and reg. section 1.951A-5(b)(1) provide that an amount included in a U.S. shareholder's gross income as a GILTI inclusion amount is treated in the same manner as an amount included under section 951(a) for purposes of applying section 961. Reg. section 1.961-1(a) provides that the increase occurs "as of the last day in the tax year of such corporation on which it is a controlled foreign corporation."

Under section 961(b)(1) and reg. section 1.961-2(a), the adjusted basis of stock with respect to which a U.S. shareholder receives an amount excluded from gross income under section 959(a) is generally reduced by the amount excluded and the amount of certain foreign taxes. Reg. section 1.961-2(a) provides that the reduction of adjusted basis occurs "as of the time such person receives such excluded amount."

Section 961(b)(2) and reg. section 1.961-2(c) do not specifically address a scenario like the midyear distribution. The memo states that the timing rules in reg. sections 1.961-2(a) and -1(a) could be read to conclude that the adjusted basis of USP's FS stock is computed before or after taking into account the $100 increase under section 961(a).

The IRS determined that the better interpretation is that the increase in basis is taken into account when applying section 961(b)(2) and reg. section 1.961-2(c) to the midyear distribution. The IRS further states that not doing so would produce discordance between sections 959 and 961, because under section 959(c) the full amount of PTEP for a tax year is available (without duplication) for distributions made at any time during the year, but under section 961 the basis related to that PTEP would protect against section 961(b)(2) gain only if the PTEP is distributed on or after the last day of the tax year on which the foreign corporation is a CFC. The IRS reasons that requiring gain recognition under section 961(b)(2) if the PTEP is distributed on any earlier day would be contrary to section 959 and section 961's common purpose of preventing double taxation.

Thus, under the facts in the memo, at the end of Year 1, without diminution for distributions, FS had earnings and profits of $100x, and thus the midyear distribution would be, without regard to section 959(d), a dividend. The distribution was treated as an amount described in section 959(a). The entirety of the midyear distribution was excluded from USP's gross income. USP correspondingly decreased its PTEP accounts with respect to FS by $100x.

IRS Guidance on Sourcing

Peter H. Blessing, associate chief counsel (international), drafted AM 2023-001, dated February 24, addressing the character and source of a U.S. depositary institution's payments to a foreign corporation to establish sponsored

[10] *See* Neumann, Ushakova-Stein, and Knobler, *supra* note 5, at 1229.

American depository receipts (ADR) programs with holders located both inside and outside the United States, and payments by the depositary institution to the corporation under a revenue-sharing arrangement. The memo concludes that the United States — the location of the capital markets — is the place of use in this case and hence is the source of the ADR program payments.

Corporate issuers of stock may use depository receipts programs to make their stock more accessible to investors in foreign markets. Depository receipts programs that make stock of foreign issuers ("issuers") available in U.S. markets are known as ADR programs. An ADR is a negotiable certificate that evidences ownership of American depository shares, which, in turn, represent an interest in a specified number (or fraction) of an issuer's shares.

ADRs are created by a U.S. depository institution (usually a U.S. bank or trust company) (DI) when the foreign issuer, or an investor who already holds the underlying foreign securities, deposits the foreign securities with the DI or its custodian in the foreign issuer's home country. The DI then issues ADRs representing those shares to the investor ("holder"). The holder will be able to resell the ADRs on a U.S. stock exchange or the over-the-counter market. ADR holders may also surrender ADRs in exchange for receiving the shares of the issuer.

A sponsored ADR program is established jointly by an issuer and a DI and represents the vehicle by which the issuer sponsors the ADRs' entry into the U.S. capital markets. The issuer establishes a sponsored ADR program by appointing a DI as the exclusive depository and agent for the issuance and other activities in respect of ADRs for the issuer's stock in the United States. The issuer of the deposited securities enters into a deposit agreement with the DI and signs the SEC Form F-6 registration statement.

The issuer incurs expenses to institute an ADR program. As an inducement to grant an exclusive arrangement for a sponsored ADR program, it is common for the DI to offer to pay a portion of the expenses the issuer will incur in setting up the program. Under a typical deposit agreement, the issuer must seek payments from the DI within a specified time.

Instead of a reimbursement arrangement, some sponsored ADR program deposit agreements provide for revenue-sharing arrangements. In these cases, a DI may pay the issuer a percentage of fees collected from holders.

Payments by the DI to the issuer, or to third parties on behalf of the issuer, for the issuer's expenses or otherwise under a reimbursement arrangement, and payments under a revenue-sharing arrangement, are gross income of the issuer. Section 881 imposes a 30 percent tax on the gross amount of U.S.-source fixed or determinable, annual, or periodical income derived by a foreign corporation that is not effectively connected with the conduct of a U.S. trade or business. Fixed or determinable, annual, or periodical income generally includes all amounts included in gross income under section 61 other than gains from the sale of property.

The IRS provided that both types of payments represent consideration for the DI's exclusive right to establish, control, and exploit the trading of the foreign corporation's ADRs in the United States. This right constitutes a property right made available by the foreign corporation for use for a limited period of time solely in the United States, regardless of whether the holders are located inside or outside the United States, and thus both types of payments to the foreign corporation are treated as income solely from sources within the United States and, absent treaty relief, are subject to withholding of U.S. tax. The memo reasons that the United States — the location of the capital markets that the DI is accessing to profit from holders trading in ADRs and to which the U.S. securities laws apply — is the place of use in this case and hence is the source of the ADR program payments. ■