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In this installment of U.S. Tax Review, the authors review recent developments in *3M*, *Microsoft*, and *Eaton*, as well as recent guidance on the dual consolidated loss rules and comments on the OECD two-pillar approach.

3M

In a "reviewed by the court" opinion, a sharply divided Tax Court held in *3M*[1] that the IRS has the authority to reallocate foreign income under section 482 when that income is blocked under foreign law.

The Tax Court split 9 to 8, with seven judges joining a plurality opinion, two concurring in the result (and joining in a five-judge concurrence), and eight dissenting (in three dissenting opinions). There were six opinions, 346 pages, and no consensus. However, both the plurality and the concurrence (and therefore a majority of the court) held that reg. section 1.482-1(h)(2), which limits the extent to which foreign law curtails the IRS's powers under section 482, is valid in light of the statute's "commensurate with the income" sentence. Given the lack of a majority opinion, it is questionable how much precedential value this case has.

The IRS asserted a transfer pricing adjustment against 3M, claiming that additional royalty payments should be made for intangible property used by a Brazilian subsidiary (3M Brazil). 3M argued that the section 482 transfer pricing adjustment was improper because an additional royalty payment would have violated Brazilian law. 3M challenged the validity of reg. section 1.482-1(h)(2), which governs when foreign legal restrictions are considered for transfer pricing purposes. The plurality determined that reg. section 1.482-1(h)(2) was valid and that the Brazilian legal restriction at issue would not be taken into account under the regulation.

As of the 2006 tax year, the multinational group of which 3M Company is the common parent (3M Global) was one of the largest technology and manufacturing enterprises in the world, stating in its annual report that it had over $23 billion in worldwide gross sales and over $21 billion in worldwide assets.

In 1999 the U.S. parent company (3M Company) decided that much of its intellectual property should be held and managed by a newly formed U.S. subsidiary, 3M Innovative Properties

[1] *3M Co. v. Commissioner*, 160 T.C. No. 3 (2023).

Company (3M IPC). 3M Company also added to its corporate structure another newly formed U.S. corporation, 3M Financial Management Company (3M Financial Management). The purpose of 3M Financial Management was to facilitate currency management and intercorporate lending between 3M Company and its affiliates. The ownership structure of the four corporations was as follows:

- 3M Company owned 3M Financial Management;
- 3M Financial Management owned 3M IPC; and
- 3M IPC owned 3M Brazil.

3M Company then assigned and licensed all IP to 3M IPC, except for trademarks, to which it retained ownership.

3M Brazil's primary business operations included the manufacturing and distribution of 3M Global's products. Neither 3M Company nor 3M IPC owned any plant, property, or equipment in Brazil. 3M Brazil reported for U.S. income tax purposes about $563 million in sales and employed about 3,120 people at its corporate headquarters and its three manufacturing sites throughout Brazil, including a research and development facility at one of the manufacturing sites.

During the 2006 tax year, 3M Company and 3M IPC jointly licensed the 3M IP to most affiliates using a standard licensing agreement with a royalty of 6 percent of net sales. 3M Brazil was not among those affiliates. In Brazil, 3M Brazil paid a royalty to 3M Company for licensing trademarks, but did not license patents and other unpatented technology. The Brazilian Patent and Trademark Office prevented 3M Brazil from making royalty payments for patents and unpatented technology. The trademark licenses required 3M Brazil to pay 3M Company 1 percent of its net sales. The royalty was calculated using a stacking principle under which if a product used multiple trademarks covered by three separate agreements, then the licensee (3M Brazil) paid up to a 3 percent trademark royalty.

The IRS asserted that Brazil royalties should have been paid by 3M Brazil to 3M IPC on 6 percent of the net sales and made an adjustment of over $23 million.

3M argued that Brazilian law precluded 3M Brazil from paying any royalties other than the 1 percent trademark royalties. 3M conceded that the $23 million allocation reflects an arm's-length compensation for the use of the IP. However, it disputed the IRS's legal authority to make an allocation under section 482 because 3M Brazil was prevented under Brazilian law from paying more than the trademark royalty.

To support its position, 3M cited:

- the text of section 482;
- the legislative history of section 482; and
- four cases[2] in which courts held that, under prior versions of section 482 and its regulations, the IRS did not have authority to allocate income to a taxpayer that the taxpayer did not receive and could not legally receive.

Reg. section 1.482-1(h)(2) was promulgated in 1994, after the tax years at issue in the above cases. The IRS argued that reg. section 1.482-1(h)(2) applied to the 2006 tax year at issue in *3M*. 3M contended that the 1994 regulation is invalid under various administrative law principles and therefore is not controlling.

The plurality opinion provided a 149-page detailed summary of the legislative history of section 482, the Administrative Procedure Act, and the case law starting with the Revenue Act of 1921 and ending with the 2018 amendments to section 482. The opinion then analyzed whether the Brazilian legal restrictions satisfy the seven requirements in reg. section 1.482-1(h)(2) (2006) for taking into account foreign legal restrictions for transfer pricing purposes.

Reg. section 1.482-1(h)(2) (2006) provides that a foreign legal restriction is taken into account in making allocations under section 482 if seven requirements are met:

> 1) the restriction affected uncontrolled taxpayers under comparable circumstances for a comparable period;

[2] *L.E. Shunk Latex Products Inc. v. Commissioner*, 18 T.C. 940 (1952); *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972); *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992), *aff'g* 95 T.C. 323 (1990); and *Exxon Corp. v. Commissioner*, T.C. Memo. 1993-616, *aff'd sub nom. Texaco Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996).

2) the restriction was publicly promulgated;

3) the restriction was generally applicable to all similarly situated persons (both controlled and uncontrolled);

4) the restriction was not imposed as part of a commercial transaction between the taxpayer and the foreign government;

5) the taxpayer exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of the restriction (other than remedies that would have a negligible prospect of success);

6) the restriction expressly prevented the payment or receipt, in any form, of all or part of the arm's-length amount; and

7) the taxpayer and related parties did not engage in any arrangement with controlled or uncontrolled parties that circumvented the restriction and did not materially violate the restriction.

3M did not dispute that the Brazilian restrictions failed the first, third, fourth, and sixth requirements. On the second requirement, 3M argued that the Brazilian Patent and Trademark Office interpretation of Brazilian law should be considered publicly promulgated even though 3M conceded that the agency's interpretation was unwritten; the plurality opinion disagreed. The plurality did not resolve the fifth and seventh requirements because it determined that five of the other seven requirements were not satisfied.

The plurality rejected 3M's argument that the Supreme Court in *First Security Bank* determined that the plain meaning of section 482 precludes the interpretation adopted in reg. section 1.482-1(h)(2) and held that *First Security Bank* was not decided under step one of the tests set forth in *Chevron*.[3]

The plurality also held that the four opinions cited by 3M were distinguishable because they construed the pre-1986 statutory provision that lacked the commensurate with income sentence. The plurality did not agree with 3M that the scope of the commensurate with income sentence added in 1986 is limited and does not broadly expand the scope of the IRS's powers under section 482 to disregard what is considered taxable income under foreign law.

3M also argued that an "arbitrary shifting of profits" under section 482 can result only from the voluntary setting of intercompany prices by the common owners of related companies. The plurality disagreed and stated that a legal restriction on intercompany payments could also arbitrarily shift profits under section 482. The plurality stated that even if the purpose of section 482 (as originally enacted in the Revenue Act of 1921) were to prevent the voluntary shifting of profits, "this does not mean that section 482 of the Internal Revenue Code of 1986 has the same purpose." The plurality seems to be suggesting that the second sentence in section 482, the commensurate with income sentence, changed the purpose and intent of the first sentence of section 482. That would be a troubling conclusion.

The plurality said its ruling did not depend on that conclusion. Even if section 482 should be narrowly interpreted to confine the IRS to correcting "arbitrary shifting of profits," the plurality said, a legal restriction on intercompany payments could arbitrarily shift profits and therefore justify a section 482 allocation.

Chief Judge Kathleen Kerrigan made a similar argument in her concurring opinion: Because the Brazilian blocking statute prevents 3M Company from receiving royalty income that is "commensurate with the income attributable to the intangible," the regulation disregards that blocking statute and thereby accomplishes Congress's purpose in enacting the commensurate with income standard in the second sentence of section 482 (the 1986 amendment).

Chief Judge Kerrigan's concurrence and a separate concurring opinion by Judge Elizabeth Copeland both state that the 1986 amendment to section 482 was a significant change to the statute. "None of the cases cited in Judge [Ronald L.] Buch's dissent interpreted the version of section 482 that controls this case," Chief Judge Kerrigan wrote. Judge Copeland wrote that "the result of this case is dictated by the plain text of section 482 — specifically, the second sentence added by

[3] *Chevron v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 844 (1984).

amendment in 1986." Each joined in the other's concurring opinion.

Having rejected the argument that reg. section 1.482-1(h)(2) is invalid under *Chevron* step one, the plurality then considered the argument that portions of the regulation are invalid under *Chevron* step two. A regulation satisfies *Chevron* step two if it is a "reasonable interpretation" of the statute.[4] 3M argued that various requirements imposed by the regulation are not reasonable interpretations of section 482.

3M argued that the first requirement of the regulation regarding the effect on uncontrolled taxpayers is invalid. 3M's argument had two parts. First, that section 482 should be interpreted to address only misallocations of income attributable to controlled transactions; second, that a transaction is not a controlled transaction to the extent that a legal restriction prevents a payment of consideration. 3M's position was that 3M Company did not control the amounts that 3M Brazil paid to 3M IPC for the use of patents and for unpatented technology. That control was exercised by the government of Brazil through its legal restrictions.

While the plurality agreed that section 482 is aimed at controlled transactions, it stated that section 482 authorizes the IRS to allocate income among commonly controlled businesses if the allocation is necessary to clearly reflect the income of the businesses. However, the plurality ruled that the statutory text authorizing the allocation of income between controlled businesses to clearly reflect their income is broad enough to accommodate Treasury's interpretation that foreign legal restrictions are taken into account only if the restrictions affect uncontrolled taxpayers.

The second part of the argument — that a transaction is a not a controlled transaction if payment for the transaction is controlled by law — is founded on the Supreme Court opinion in *First Security Bank*. The plurality admitted that *First Security Bank* seemingly implies that there can be no control without legal control but then disposes of the Supreme Court's opinion by claiming that the "complete-power" sentence on which *First Security Bank* relied is no longer in the regulatory scheme for tax years beginning after April 21, 1993. This is an important point on which Judge Buch's dissent disagrees. The Supreme Court "did not rely on that regulation, but merely cited it for the proposition that even the Commissioner recognized that blocked income could not be taxed. Indeed, the Court was clear that it was interpreting the statute, not the regulations," Judge Buch wrote. The plurality ruled that the effect-on-uncontrolled-taxpayers requirement in the regulation is a reasonable interpretation of section 482 and is consistent with the goals of the statute, which are (1) tax parity and (2) arm's-length results.

3M also argued that the second requirement in the regulation, the public-promulgation requirement, is an unreasonable interpretation of section 482 because it does not take into account the fact that many countries rely on unpromulgated administrative guidance that is nonetheless considered binding. The plurality ruled that the requirement was valid under *Chevron* step two.

3M also argued that the foreign legal restriction regulation failed the test of *State Farm*[5] because Treasury did not provide a satisfactory explanation for its actions and did not provide adequate response to comments. The plurality stated that Treasury satisfactorily explained the reason for the regulation, which was to advance the goal of tax parity. The plurality also ruled that Treasury did adequately respond to comments.

Judge Buch's dissent stated that blocked income is income that a taxpayer is prohibited by law from receiving and that blocked income cannot be taxed. The IRS can use section 482 in myriad ways to allocate income among commonly controlled entities, but that taxpayer must have "complete power" over that income, he argued.

The Buch dissent stated that section 482 is silent on blocked income, and the regulations in effect from 1934 through 1993 did not explicitly purport to tax blocked income. The IRS

[4] *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011); *Chevron*, 467 U.S. at 844.

[5] *Motor Vehicle Manufacturers Association of the United States Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

repeatedly attempted to use section 482 (and its predecessor) in an effort to tax blocked income and lost in court. Faced with a string of losses, Treasury promulgated regulations purporting to authorize the allocation, and thus taxation, of blocked income.

In *Brand X*,[6] relying on the framework set forth in *Chevron*, the Court held that:

> a prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.

Judge Buch argued that the Supreme Court, in deciding *First Security Bank*, foreclosed the allocation, and thus the taxation, of blocked income. Without using the word "unambiguous," the Court made clear that blocked income is not, and cannot be, allocated to someone who did not and cannot receive it. Every court to have considered *First Security Bank* in the context of blocked income has understood it as describing a limit on the IRS's power to allocate income, the Buch dissent argued.

The Buch dissent then stated:

> If the Supreme Court had not already answered the question before us, a court would need to turn to the plain meaning of "income" to determine whether a taxpayer could be taxed on income that it did not receive and that it was prohibited from receiving. Because I would find *First Security Bank* controlling, I need not answer that question. But because the opinion of the Court does not find *First Security Bank* controlling, it must wrestle with interpreting the operative statute.

The Buch dissent argued that 3M had a blocked income problem in that its Brazilian subsidiary was compelled by foreign law to pay below-market royalty rates. In *First Security Bank*, the Supreme Court held that section 482 cannot be used to allocate blocked income to someone who did not receive it and could not receive it. The Buch dissent argues that Congress has not amended section 482 in any way that would materially alter the Supreme Court's holding in *First Security Bank*.

Judge Richard Morrison wrote the plurality opinion, in which Chief Judge Kerrigan and Judges Joseph Gale, David Gustafson, Joseph Nega, Tamara Ashford, and Alina Marshall joined. Judges Copeland and Elizabeth Crewson Paris concurred with the result only. Chief Judge Kerrigan filed a concurring opinion, in which Judges Gale, Paris, Ashford, and Copeland joined. Judge Copeland filed a separate concurrence, in which Chief Judge Kerrigan and Judges Gale and Paris joined. Judges Patrick Urda, Courtney Jones, Emin Toro, and Travis Greaves joined in Judge Buch's dissent. Judge Cary Douglas Pugh also wrote a dissent, in which Judges Maurice Foley, Buch, Urda, and Toro joined. Judge Toro filed a dissent, in which Judges Buch, Urda, Jones, Greaves, and Christian Weiler joined.

Microsoft FOIA Case

In *Microsoft*,[7] the court held that the IRS was not required under the Freedom of Information Act to search for and provide records of outside law firms that the IRS used during its audit. The IRS began an audit of Microsoft in 2007 for the tax years of 2004 through 2006 and hired Boies Schiller Flexner LLP and Quinn Emanuel Urquhart & Sullivan LLP to assist in its section 482 examination of Microsoft.[8] The decision to hire outside law firms to assist in the audit was heavily criticized. The opinion notes that this audit of Microsoft is one of the largest audits in the Service's history.

Previously in *United States v. Microsoft*,[9] the court enforced summonses that Microsoft argued were invalid partly because of the outside law firms' involvement in the audit. The court was troubled by the law firms' level of involvement but ruled that Microsoft failed to prove that the summonses were issued in bad faith or for an

[6] *National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967 (2005).

[7] *Microsoft Corp. v. IRS*, No. 2:15-cv-01605 (W.D. Wash. 2023).

[8] For prior coverage, see James P. Fuller and Larissa Neumann, "U.S. Tax Review," *Tax Notes Int'l*, May 7, 2018, p. 727.

[9] *United States v. Microsoft Corp.*, No. 2:15-cv-00102 (W.D. Wash.).

improper purpose. The court stated that the firms' involvement might draw congressional scrutiny and that "the idea that the IRS can 'farm out' legal assistance to a private law firm is by no means established by prior practice." A month after the IRS hired outside counsel to work on Microsoft's IRS examination, the IRS and Treasury issued section 7602 regulations allowing contractors to participate in summons interviews.

The FOIA requests sought records relating to the contracts with Boies Schiller and Quinn Emanuel. They also sought records on the section 7602 regulations and the designated summons issued to Microsoft.

Under FOIA rules, there is a judicially enforceable right to secure government information to ensure an informed citizenry, to check against corruption, and to hold the government accountable. Federal agencies have a duty to construe FOIA requests liberally and must demonstrate a search reasonably calculated to uncover all relevant documents.

The court held that the IRS was not required to search records outside its possession. Those records are not "agency records" for purposes of the FOIA. An agency's contractual "right of access" to materials held by a private party is not dispositive as to whether such materials are "agency records." The FOIA excludes "government contractor" from the definition of "agency" (*see* 5 U.S.C. section 552(f)(1)). For contractor-created materials to be transformed into "agency records," they must have been received by the agency.

Microsoft then argued that attorney-client privilege cannot apply to documents created by the contractors because the attorneys provided audit support, not legal counsel. Microsoft also argued that the attorney-client privilege does not apply to communications regarding the proposed and temporary regulations.

The IRS argued that the outside law firms were involved in preparing, organizing, and presenting the factual record and legal analysis of the case.

The court stated that at times the IRS portrayed its use of the contractors differently. However, overall, the court found that the attorney contractors were hired in part for legal analysis and that a rebuttable presumption of privilege applies. The court stated that this was not a routine examination in which contractors could be assumed to be doing routine auditing work rather than providing legal advice.

Eaton's APA Case

Eaton Corp. and the IRS have reached a stipulated resolution to their landmark case regarding the rights of taxpayers and the IRS under advance pricing agreements. Under the decision[10] entered February 3 in the wake of the IRS's unsuccessful appeal of Judge Kerrigan's 2017 ruling (*Eaton Corp. v. Commissioner*, T.C. Memo. 2017-147), the parties stipulated to deficiencies of approximately $4.7 million for 2005 and $4.6 million for 2006, with no penalties for either year. The IRS had assessed deficiencies and penalties totaling about $126.7 million.[11]

In *Eaton Corp. v. Commissioner*, 47 F.4th 434 (6th Cir. 2022), the Sixth Circuit held that the IRS improperly canceled APAs with Eaton, which the court treated as contracts between the two parties.[12] Inadvertent calculation errors, discovered and corrected by Eaton, did not provide sufficient grounds for canceling the APAs.

Tax Attorney-Client Privilege Case

On January 23 the Supreme Court dismissed the writ of certiorari in *In re Grand Jury* as improvidently granted.[13] The case, on appeal from the Ninth Circuit, was noteworthy because it addressed attorney-client privilege issues in the tax context and might have affected taxpayers' ability to claim privilege for communications relating to a tax return or other document meant to be disclosed to the IRS, even if the communications contained significant elements of legal advice.[14]

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[10] *Eaton Corp. v. Commissioner*, 5576-12 (2023).

[11] 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.

[12] For prior coverage of the Sixth Circuit's *Eaton* decision, see Neumann and Julia Ushakova-Stein, "U.S. Tax Review: *Eaton*, *Zehnder*, *Caterpillar*; PFIC, BEAT, and Other Priority Guidance," *Tax Notes Int'l*, Oct. 3, 2022, p. 31.

[13] *In re Grand Jury*, No. 21-1397 (S. Ct. 2022).

[14] Thank you to our colleague, Sean McElroy, for his input in this section.

The dismissal, in a one-line per curiam opinion without explanation, came shortly after the Court heard oral argument. This is a fairly uncommon way for the Court to dispose of a case. While the Supreme Court acceptance rate is low, once cases are accepted the Court typically issues an opinion.

In re Grand Jury concerned whether a communication involving both legal and nonlegal advice — often referred to as a dual-purpose communication — is protected by the attorney-client privilege. In the case, an unidentified tax law firm refused to turn over 56 documents containing dual-purpose communications. These documents contained, for example, interpretations of unsettled reporting requirements, strategies for filing amended income tax returns, and the client's questions about and comments on draft penalty abatement submissions to the IRS.

The case would have resolved a circuit split on when dual-purpose communications are privileged. In this case, the Ninth Circuit applied the primary purpose test, under which attorney-client privilege applies only if the primary purpose of the communication was to provide legal advice.[15] The government argued for this test.

However, the District of Columbia Circuit (in an opinion by now-Justice Brett Kavanaugh) applied the significant purpose test, under which the analysis revolves around whether the legal advice was one of the significant purposes of the communication.[16] The taxpayer in *In re Grand Jury* favored this standard. In another case,[17] the Seventh Circuit held that dual-purpose communications in the tax advice context can *never* be privileged, but neither party advocated for that standard in briefing before the Court in *In re Grand Jury*.

One amicus brief, by the Silicon Valley Tax Directors Group (SVTDG), argued that applying the primary purpose test would create a "watered-down privilege rule applicable to tax only," for example, on transfer pricing advice.

[15] *In re Grand Jury*, 13 F.4th 710 (9th Cir. 2021).

[16] *In re Kellogg Brown and Root Inc.*, 756 F.3d 754 (D.C. Cir. 2014).

[17] *Frederick v. United States*, 182 F.3d 496 (7th Cir. 1999).

Section 961 Guidance

In LTR 202304008, which addresses foreign use for purposes of the dual consolidated loss rules, the IRS helpfully ruled that a section 961(a) basis increase will be taken into account when determining the extent to which a distribution in the same year requires a basis reduction under section 961(b)(1) and gain recognition under section 961(b)(2).

LTR 202304008 supplements LTR 202110015 as a result of three date changes and the addition of the distribution. The dual consolidated loss portion of the 2023 ruling is essentially unchanged from the prior ruling.[18] The section 961 ruling, however, is new.

In the ruling, a domestic parent corporation wholly owns a domestic corporation, US-1, that wholly owns a foreign corporation, F-1, which will transfer assets to US-1 in exchange for cash. In the same year as that asset sale, F-1 will distribute cash (including cash received in the asset sale) to US-1 (the distribution).

The parent represented that it and US-1 will compute and report the consolidated taxable income for the year of the distribution in accordance with Notice 2019-1, 2019-3 IRB 275, regarding previously taxed earnings and profits (PTEP). Also, US-1 will include in its income for the year of the distribution subpart F and global intangible low-taxed income inclusions, giving rise to an increase to US-1's PTEP accounts for FC-1 and an increase under section 961(a) in US-1's adjusted basis in its stock of FC-1 (the section 961(a) basis increase). All or a portion of the distribution will be excluded from US-1's gross income under section 959(a). Other than the distribution, FC-1 will not have made any actual or deemed distributions in the year of the distribution on or before the date of the distribution.

The adjusted basis of the FC-1 shares at the time of the distribution, without regard to the section 961(a) basis increase, will be less than the reduction under section 961(b)(1) as a result of the distribution.

[18] For prior coverage of LTR 202110015, see Fuller and Neumann, "U.S. Tax Review," *Tax Notes Int'l*, Apr. 5, 2021, p. 33.

The IRS ruled that for each share of FC-1 stock, US-1 will take into account the appropriate portion of the section 961(a) basis increase with respect to the share when determining the extent to which US-1 is required to reduce the share's adjusted basis under section 961(b)(1) and recognize gain with respect to the share under section 961(b)(2) as a result of the distribution.

The ruling appears to provide a sensible solution to a timing issue that has taken on a heightened importance for taxpayers as a result of the GILTI regime. Taxpayers have been concerned that reg. sections 1.961-1 and -2 could result in basis decreases from PTEP distributions being treated as occurring before basis increases from GILTI and subpart F inclusions that occur in the same tax year. Although LTR 202304008 offers no explanation for the ruling and private letter rulings are non-precedential, it nonetheless offers some comfort in advance of the publication of new PTEP regulations expected later this year.

Revised Dispute Resolution Method

The OECD inclusive framework has announced a new method for the peer review process aimed at improving the resolution of double taxation disputes. As part of an ongoing effort to increase the timeliness and efficiency of dispute resolution mechanisms, jurisdictions will be reviewed based on their success at:

- preventing disputes;
- availability and access to the mutual agreement procedure;
- resolution of MAP cases; and
- implementation of MAP agreements.

The first stage involves peer review of a jurisdiction's implementation of the minimum standard based on its legal framework for MAP and the application of this framework in practice. The second stage involves the review of the measures taken by the jurisdiction to address any shortcomings identified in stage 1. After the initial reviews, jurisdictions with "meaningful MAP experience" will undergo further peer reviews every four years. Jurisdictions without meaningful MAP experience will undergo simplified peer review beginning this year, with the last batch of reviews scheduled to start in May 2025.

Jurisdictions will be required to report the average time to close cases in the unilateral and bilateral stages of MAP and to identify the age of pending cases. Beginning in 2024, APA statistics will also be made available in jurisdictions that enter into them.

Pillar 2 Administrative Guidance

On February 2 the OECD issued administrative guidance on the global anti-base-erosion (GLOBE) rules confirming that the United States' GILTI regime is an example of a blended controlled foreign corporation tax regime for the purposes of pillar 2 of the inclusive framework.[19] This means that in-scope U.S. multinationals will not be able to rely on the GILTI regime to shield them from imposition of top-up taxes in foreign jurisdictions. It also means that the GILTI taxes imposed on the U.S. parent will be allocated to its foreign subsidiaries, thereby increasing their effective tax rates and reducing their top-up tax exposure.

The guidance contains a temporary rule for allocating taxes imposed under GILTI and other blended CFC tax regimes to the entities whose income forms the base of the tax. Once the taxes are allocated, the entities' effective tax rates can be determined, and then top-up taxes could bring those rates up to 15 percent, the minimum effective tax rate under pillar 2.

The allocable GILTI tax for an in-scope U.S. shareholder without a domestic loss is the shareholder's GILTI inclusion, reduced by the GILTI deduction, and then multiplied by the 21 percent U.S. corporate tax rate, minus the foreign tax credit in the GILTI basket. That tax is allocated among the relevant CFCs in proportion to the ratio of each CFC's "blended CFC allocation key" to the sum of all blended CFC allocation keys for CFCs in which the taxpayer is a United States shareholder. The blended CFC allocation key is defined as the product of the United States shareholder's proportionate share of the CFC's income and the excess, if any, of the "applicable rate" over the "GLOBE jurisdictional ETR [effective tax rate]."

[19] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)," at section 2.10.1(4) (Feb. 2, 2023).

The applicable rate is the minimum rate at which foreign tax on CFC income generally fully offsets the CFC tax; for GILTI, it is 13.125 percent. The GLOBE jurisdictional ETR is the effective tax rate for a jurisdiction under the GLOBE rules without regard to covered taxes under a CFC tax regime. If the GLOBE jurisdictional ETR equals or exceeds the applicable rate, the blended CFC allocation key is zero.

The GLOBE jurisdictional ETR includes qualified domestic minimum top-up taxes (QDMTTs) only if the blended CFC tax regime allows an FTC for the QDMTT on the same terms as any other creditable covered tax.

The temporary rule applies for fiscal years beginning on or before December 31, 2025, but not including a fiscal year that ends after June 30, 2027.

The guidance also provides a special rule that should prevent specific U.S. tax credits that are structured through partnerships, such as credits for low-income housing and renewable energy, from lowering the taxpayer's effective tax rate under pillar 2. The special rule covers "qualified flow-through tax benefits," which are tax credits (other than "qualified refundable tax credits") and the tax benefits of losses that flow to an investor as a return of basis rather than as a return on investment. The rule applies only when, at the time of the investment, the investor's expected return on its interest in the partnership would not be positive in the absence of the expected nonrefundable credits.

The guidance announces rules for determining whether a tax is a QDMTT. One requirement is that a multinational entity be able to use the same data to calculate its QDMTT liability as it uses to calculate its GLOBE tax liability. Furthermore, the QDMTT must not systematically result in an incremental top-up tax that is less than would arise under the GLOBE rules. A QDMTT must apply to domestic constituent entities of in-scope MNE groups but can apply more broadly. Specifically, the definitions of ultimate parent entity, MNE group, and constituent entity in the QDMTT need to correspond with the definitions in the GLOBE rules; and the QDMTT must compute the tax liability for the jurisdiction by taking into account the income and covered taxes of constituent entities that are located in the jurisdiction as determined under the GLOBE rules.

The guidance provides numerous details about the application of the GLOBE rules to insurance companies and answers many other administrative questions. For example, if one member of a multinational group classifies an instrument as debt and another classifies it as equity, the GLOBE rules will resolve any asymmetric accounting treatment by applying the accounting treatment used by the issuer to both the issuer and the holder. If jurisdictions choose to implement the GLOBE rules based on amounts denominated in a currency other than the euro, those amounts must be normalized to the euro-denominated thresholds based on the average foreign exchange rate for the December before the relevant calendar year. If multiple years are included in a calculation, separate foreign exchange rates would be used to determine the amount in local currency for each relevant year.

Entertainment Amount A Comments

Five entertainment industry multinational businesses provided comments to draft multilateral convention provisions on digital services taxes released by the inclusive framework. In a January comment letter responding to the amount A consultation, Viaplay, Netflix, Sky, Warner Bros. Discovery, and Paramount Global stated that the provisions were insufficient to shield taxpayers from double taxation resulting from unilateral DSTs and relevant similar measures (RSMs).

The businesses contend that the draft multilateral convention provisions:

> (1) do not contain an appropriate remedy for any party that is subject to a DST/RSM, (2) do not provide a complete definition of DST/RSM that adequately applies to the types of discriminatory taxes/levies that the [inclusive framework] agreed to roll back and not enact in the future, (3) contain a list of exclusions from the DST/RSM definition that are concerning and/or unclear, (4) lack an effective mechanism for avoiding double taxation, and (5) do not provide for a timely and efficient process to determine whether a challenged tax is a DST/RSM.

In its current form, the businesses say, the draft allows countries to choose between receiving an amount A allocation under pillar 1 or imposing a DST or RSM. The businesses recommend "additional barriers and disincentives" for countries to impose a DST or RSM or fail to withdraw one they have already enacted. The comment letter also calls for clear definitions of what constitutes a DST or an RSM "on the basis of their nature and economic impact" rather than their name. Specifically, the letter suggests that a tax should be a DST or RSM if it:

- applies based on location of users, customers, or market-based criteria;
- targets a particular industry, either by its terms or in practice;
- discriminates against nonresidents or foreign-owned business, either by its terms or in practice;
- creates an unlevel playing field through the application of arbitrary distinctions, such as between off-line and on-line or between domestic and foreign;
- is extraterritorial and based on gross income or income imputed from gross revenue;
- otherwise deviates from international norms; or
- has been determined to be discriminatory under the provisions for review of such taxes under the multilateral convention.

Comments on Proposed FTC Regulations

Numerous comments were submitted on the proposed FTC regulations (REG-112096-22) that were released in December.[20]

The SVTDG recommended clarifying some aspects of the requirement to recover substantially all of each item of significant cost or expense under the cost recovery requirement. The SVTDG asked for Treasury and the IRS to clarify that an expense like goodwill amortization is a subcategory of one of the per se items listed in reg. section 1.901-2(b)(4)(i)(B)(2) (specifically capital expenditures), and not a per se "item" on its own. SVTDG also asked that Treasury and the IRS provide that the "substantially all" test applies to the broader category of capital expenditures, rather than solely to the subcategory of goodwill amortization, so that foreign tax law meets the requirement in cases in which, for example, it generally permits the recovery of all expenses that make up capital expenditures, except for acquired goodwill.

The SVTDG reiterated concerns about the attribution requirement for foreign taxes imposed on residents because they were not altered by the proposed regulations. Specifically, the requirement that any allocation to or from the resident be determined under arm's-length principles can cause the taxes imposed by developing countries that have not fully adopted transfer pricing rules that align with OECD principles to be non-creditable. The SVTDG asked Treasury to structure this arm's-length requirement to take into account the possibility that lower-capacity tax administrations may impose measures that are not based on an audit-intensive analysis of assets, risks, and functions but are still intended to approximate an arm's-length return. This requirement would allow for residents to account for measures that, while not actually determined by U.S.- or OECD-style transfer pricing principles, generally produce results that are consistent with such principles.

In addition, the SVTDG requested that Treasury and the IRS delay implementation of the final regulations for one year with respect to the Brazilian corporate income tax (including withholding taxes on payments such as royalties and services) to give Brazil time to implement its transfer pricing law changes.

The SVTDG further emphasized the incongruity between the stated intent of the final FTC regulations to deny creditability for recently enacted novel unilateral measures, such as DSTs, and their actual effect of denying creditability for many previously creditable foreign withholding taxes on services (such as withholding taxes on fees for technical services), which are prevalent throughout the world, particularly in Asia and Latin America. The SVTDG strongly recommended that Treasury align the FTC regulations with OECD guidance to ensure that U.S. businesses receive relief from double taxation for any measure not listed or deemed a DST or

[20] For coverage of the proposed regulations, see Neumann and Ushakova-Stein, "U.S. Tax Review: Proposed Regs, Audit Disclosure, MAP Stats," *Tax Notes Int'l*, Jan. 2, 2023, p. 31.

RSM under the multilateral convention. At present, the draft definition of DSTs and RSMs would not capture common withholding taxes on services that have been creditable in the United States for years. Alternatively, Treasury and the IRS should provide carveouts for withholding taxes imposed on payments for services along the lines of the single-country license exception for royalties because there is no reason to differentiate between services and royalties.

The SVTDG also recommended that the updated source-based attribution rule for royalties could benefit from further clarification to help taxpayers apply this rule to the variety of foreign statutes, as they rarely align solely with the U.S. statutory expression of source or the "place of use" standard. Of main concern is how the updated rule would apply to common formulations of foreign statutes that either: (1) use multiple factors, including residence of the payer, to define which taxpayers or payments are within the scope of the royalty withholding tax, or (2) apply withholding taxes if the payer is either a resident or the IP is used in the country imposing the withholding tax. Treasury and the IRS should make clear that a foreign tax law that includes multiple factors to determine the source of royalty income and/or whether withholding tax applies to a payment of royalties should not be interpreted to mean that the foreign country's source rule is "based on the location of the payor."

The SVTDG strongly recommended that Treasury and the IRS refrain from imposing documentation requirements that focus on the form of an agreement, especially when form is often not determinative under foreign tax law. Characterization as a royalty should instead depend on the characterization of the payment under foreign tax law. This is especially important when there is a mismatch between the U.S. and foreign characterization of a payment, or uncertainty about the characterization in the foreign jurisdiction. In particular, there may be significant practical difficulties for U.S. companies if they have to renegotiate third-party agreements to include the required terminology.

The SVTDG recommended that any documentation requirements defer to proof of the characterization under foreign tax law. If Treasury and the IRS retain the requirement for the legal agreement under which payments are made to "characterize the payment as a royalty," then the SVTDG requested guidance to clarify that the naming convention of the payment is not determinative for U.S. tax purposes and that the license need not be in a stand-alone agreement to satisfy the single-country license exception. The SVTDG also requested that Treasury and the IRS delay the date the required agreement must be executed from May 17 to when the regulations are finalized and do this via a notice. This is particularly important, because it would be exceedingly difficult to comply with this requirement for agreements with unrelated third parties.

The proposed regulations provide that the principles of section 861 "apply to determine whether the terms of the agreement misstate the territory in which the relevant intangible property is used or overstate the amount of a royalty." However, the existing authorities interpreting sections 861(a)(4) and 862(a)(4) are remarkably sparse and are not necessarily consistent in their analytical approach. As a result, the SVTDG argued that Treasury and the IRS should provide further guidance to demonstrate how the U.S.-source principles can apply for purposes of the single-country license exception. In particular, the SVTDG encouraged Treasury and the IRS to provide more specific tests for purposes of sourcing a portion of a royalty to a particular territory.

The SVTDG's first recommended test would require that the licensee have substantial business activities, which involve the licensed intangible property, in the jurisdiction imposing the royalty withholding tax. The second recommended test would deem there to be single-country use of the licensed IP by reference to the country of the first unrelated licensee, which could include an unrelated sublicensee of a related-party licensee.

The proposed regulations also state that the principles of section 482 should apply to determine whether an agreement overstates the amount of the royalty attributable to the use of the IP within the country imposing the tested foreign tax. The SVTDG recommended that Treasury and the IRS clarify that this part of the single-country license exception merely requires that the amount

of a royalty allocated to a particular jurisdiction be arm's length.

There is also a cliff effect created for disallowance of FTCs if there is any discrepancy between the amount of the royalty attributable to the use of the IP within a jurisdiction under sections 482 and 861 and the amount stated in the license agreement and paid following it, if the taxpayer knew or had reason to know of the discrepancy. The SVTDG argued that a more reasonable result would be to simply deny the amount of the FTC attributable to the overstatement.

The National Foreign Trade Council (NFTC) also provided comments to the proposed FTC regulations. Its comments were limited to the cost recovery requirement, the attribution requirement as applied to withholding taxes on royalty payments, and Brazil's potential adoption of the arm's-length standard.

The NFTC stated that although prop. reg. section 1.901-2(b)(4)(i)(C)(2) provides safe harbor rules for disallowances that are based on a "stated portion" of an item of significant cost or a receipts-based or income-based measure, these two sections fail to clarify how to determine that a disallowance is not substantially "based solely on the terms of the foreign tax law" in circumstances in which the safe harbor does not apply (that is, in circumstances in which the disallowance is not based on a "stated portion" of an item of significant costs or a receipts-based or income-based measure).

The NFTC requested guidance that a foreign disallowance should be allowed for any public policy reason reflected under the code and not only public policies supporting disallowance of deductions.

Also, it requested clarification that when the principle or motivation for a disallowance under the foreign tax law is unclear (for example, not articulated in the foreign tax law or evidenced by its legislative history), the disallowance is "consistent with" a U.S. principle if the disallowance has the same effect as a particular disallowance in the code. In addition, the NFTC argued that Treasury should clarify that all interest expense disallowances are permitted on public policy grounds.

The NFTC also asked Treasury to clarify that all restrictions against cost recovery for purchased goodwill are permitted as consistent with the principles underlying the code. This is because some jurisdictions, including Mexico, do not permit deductions for any purchase price allocated to purchased goodwill, and therefore, there cannot be any recovery of costs of purchased goodwill, including upon a subsequent disposition of the business.

The NFTC also raised concerns similar to the SVTDG's regarding needing to amend agreements with third parties to implement the single-country royalty exception. The NFTC suggested that this exception instead could require that:

- an agreement must include an adequate factual description of the relevant activity conducted by the licensee (for example, manufacturing and customer locations); and
- the taxpayer must maintain in its books and records documentation that reflects the application of section 482- and section 861-based sourcing principles.

The proposed regulations also impose limitations on the scope of the single-country license rule when the taxpayer "knows, or has reason to know," the agreement "misstates the territory" in which the intangible is used. The NFTC argued that the limitation on the single-country license rule should be modified in one of two ways: First, to include a limited presumption in favor of the taxpayer for agreements with unrelated parties; and alternatively (or in addition), the consequences for not meeting the limitation's requirements could be modified to disallow only a portion of the foreign taxes.

Also, similar to the SVTDG, the NFTC stated that the requirement that the license agreement characterize the payments as royalties is not necessary. The NFTC stated that the rule should be clarified so that it applies to any agreement that provides for payments that are treated as royalties by the foreign country imposing the tested tax. Accordingly, the rule would apply to withholding taxes on payments under an agreement that in form is not a license, but that is recharacterized by the local jurisdiction as in substance a license of IP with payment of royalties.

The NFTC recommended that the withholding tax exception of prop. reg. section 1.903-1(c)(2)(iii)(B) be amended to delete its second sentence so that even if a sale of software is treated as a sale of a copyrighted article under reg. section 1.861-18 for U.S. federal income tax purposes, foreign withholding tax imposed on the amount considered a royalty under foreign law would nevertheless qualify for the single-country license exception of prop. reg. section 1.903-1(c)(2)(iii)(A).

The NFTC recommended that a similar rule to the single-country license rule for royalties be added for service fees. Therefore, withholding taxes imposed on service fees paid for services performed in the country imposing the tax, or on the separately stated portion of service fees attributable to services performed in that country, should be deemed to meet the attribution requirement without regard to the sourcing rule applied by the country imposing the tax. The NFTC also recommended that the attribution requirement for withholding taxes on services be modified in cases in which (1) the services primarily benefit the recipient of the services in the country imposing the tax, and (2) the services do not consist of services delivered primarily over the internet or an electronic network.

Again, similar to the SVTDG, the NFTC recommended that Treasury delay implementation of the attribution requirement for taxes on residents in Brazil for a two-year period.

The Information Technology Industry Council also provided comments. It reiterated its original concerns with the rules for allocating and apportioning foreign income taxes on some disregarded transactions, including that the use of the tax book value of assets as a proxy for the accumulated after-tax income from which a remittance is paid has a materially distortive effect that causes taxes to be separated from the income to which they relate, which can result in the permanent loss of FTCs. The council recommended requiring (or allowing) taxpayers to use a more suitable proxy for accumulated earnings: a rolling three-year average of the annual earnings attributable to the remitting taxable unit.

Microsoft Comments on Amount B

Microsoft provided comments to the OECD on amount B and how it should operate.

Microsoft said that groups subject to the amount A rules should be eligible for the amount B regime for all their in-country baseline marketing and distribution activities, including the distribution of all types of goods and services, such as software and cloud services.

Microsoft also stated that, given the lack of clarity on possible amount B returns, it commissioned an economic analysis of arm's-length returns to limited-risk and value added marketing and distribution activities across industries, geographies, and levels of profitability. The analysis found that regardless of industry, geography, or company profitability, the returns for sales, marketing, and distribution activities are within a fairly narrow band and decrease as a share of system profits in highly profitable companies.

To minimize disputes with market jurisdictions, Microsoft recommended that amount B be a fixed percentage return. It found a 3.6 percent median value added distributor return across industries, regions, and profitability levels, and that marketing and distribution returns do not increase as profitability increases.

Microsoft stated that amount B will not provide certainty to a number of taxpayers if it is limited to the distribution of tangible goods and if the fixed percentage is too low, as market jurisdictions will revert to asserting that additional revenue is due to the jurisdiction because of additional functions (beyond the amount B scope) performed by the local market affiliates.

Amount B should be used as the marketing and distribution safe harbor threshold, Microsoft said. It recommended two possible approaches to providing a ceiling for amount A. One would be to compare the value added marketing and distribution fixed return (amount B) to the profit already allocated to the marketing and distribution affiliate under arm's-length principles. If the arm's-length principle allocation exceeds the marketing and distribution fixed return (amount B), then the excess should reduce or eliminate the amount A allocation.

A second approach would be to limit marketing and distribution profits in the jurisdiction to no more than the sum of the amount B fixed return allocation for the local market jurisdiction affiliate/permanent establishment and the group's amount A formulaic reallocation. If the arm's-length principle allocation is less, then there would need to be a top-up via amount A. If the allocation is equal or more, then there would be no additional amount A reallocation, and the existing allocation would be adjusted to eliminate any excess.

Microsoft argued that the local comparable exemption should be eliminated because it complicates the implementation of amount B. Local market comparables are not always available in sufficient quantity to apply the transactional net margin method; the databases used for local comparables searches are not always widely available (or require additional licenses); and conducting local searches is quite time-consuming, especially when operating in many jurisdictions. The Orbis data used by the OECD for the amount B technical analysis is a global set that can be geographically segmented. To the extent some jurisdictions are underrepresented, the OECD can consider adding additional databases such as Compustat or Capital IQ.

If the fixed marketing and distribution returns are based on the customer revenue in the market, even if not booked by the MNE's local affiliate, then there is no need for quantitative rules for the local affiliate. A simple calculation of amount B could be based on customer revenue multiplied by an arm's-length operating margin percentage.

Microsoft also argued that amount B should have a de minimis rule. Multifunctional entities (entities that perform baseline marketing and distribution, and other marketing and distribution-related activities) should be eligible for amount B by increasing the scope of amount B to include all marketing and distribution-related activities. As drafted, the consultation document would deny the benefits of amount B to countries and taxpayers even if there is minimal other activity in a jurisdiction. ■