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Congress Passes Tax Provisions in CHIPS Bill; Inflation Reduction Act

Congress engaged in a flurry of legislative activity over the past month, enacting two bills that contain important tax provisions. On August 9, 2022, President Biden signed the CHIPS and Science Act ("CHIPS Act") into law. The CHIPS Act is a bipartisan bill that has been in development and subject to debate for more than a year. Intended to boost American semiconductor research, development, and production, the CHIPS Act includes an investment tax credit for manufacturing semiconductors and related equipment in new Code Section 48D. The credit, which is effectively refundable, is 25% of the qualified investment made in a given taxable year in an advanced manufacturing facility of an eligible taxpayer. The credit applies to property placed in service after December 31, 2022, construction of which begins on or before December 31, 2026. For more information about the new credit, please see Baker's client alert.

Additionally, on August 16, 2022, President Biden signed the Inflation Reduction Act of 2022. Passed with only Democratic votes using the reconciliation process, the Inflation Reduction Act is a significantly slimmed-down version of the Build Back Better Act that the House of Representatives passed in November 2021. While the Build Back Better Act contained a substantial number of tax provisions, including extensive changes to the international tax provisions, the Inflation Reduction Act contains a much more limited number of provisions. Notably, nothing in the Inflation Reduction Act implements Pillars One or Two in the US.

To raise revenue, the Inflation Reduction Act:

- Adds a new 15% minimum tax on book income of large corporations,
- Imposes a 1% excise tax on stock buybacks of domestic, publicly-traded corporations, and
- Provides an additional $80 billion in IRS funding over a ten-year period.

The new minimum tax would apply to "large" corporations (those with average annual adjusted financial statement income of $1 billion or more), and is very similar to the minimum tax provision included in the December 2021 Senate Finance draft legislative text for the Build Back Better Act. (For more information on the previous version of this provision, see Baker McKenzie's client alert here.) New Code Section 56A defines the term Adjusted Financial Statement Income ("AFSI"), provides a list of statutory adjustments to determine AFSI (including a reduction to AFSI for depreciation deductions), and provides Treasury and IRS with a fairly broad grant of regulatory authority to make further adjustments to AFSI. The minimum tax applies to taxable years beginning after December 31,

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Upcoming Tax Events

Tech Talk Silicon Valley

► September 15

Tax Issues Affecting the Technology and Digital Economy Sector - a panel discussion with the Australian Taxation Office (ATO)

► September 19 (West Coast)
► September 20 (Sydney)
Register online
Register in-person

To review the complete Tax Events Calendar visit www.bakermckenzie.com/tax/event

2022. While Treasury is expected to issue guidance on how to determine AFSI, it is unlikely that such guidance will be issued before year-end and it is likely that the statute will become effective before taxpayers have full understanding of how to calculate AFSI.

The excise tax is a 1% excise tax on net buybacks made by a domestic, publicly-traded corporation. The Act provides a limited number of exemptions from the tax, including for stock repurchased in a tax-free reorganization, contributions of repurchased stock to employee retirement or stock ownership plans, and *de minimis* stock buybacks (which the Act defines as buybacks of $1 million or less). The excise tax is not deductible, and applies to repurchases of stock made after December 31, 2022.

Approximately half of the additional IRS funding ($45.8 billion) is allocated to tax enforcement activities, and $4.75 billion is allocated to business systems modernization and $3.2 billion is allocated to taxpayer services. On August 10, Treasury Secretary Janet Yellen wrote to IRS Commissioner Rettig to "confirm . . . that audit rates will not rise relative to recent years for households making under $400,000 annually." Instead, Secretary Yellen instructed Commissioner Rettig that "enforcement resources will focus on high-end noncompliance." The day after President Biden signed the Inflation Reduction Act, Secretary Yellen sent Commissioner Rettig a memo instructing him to work with Deputy Secretary Wally Adeyemo on an "operational plan" to use the IRS's additional resources over the next ten years. A report describing the operational plan is due to Secretary Yellen in six months.

In addition, the Inflation Reduction Act contains other tax provisions that raise revenue, including reinstating the hazardous substance superfund tax on petroleum products (effective January 1, 2023) and extending Section 461(l) for an additional two years.

On the spending side of the ledger, the Inflation Reduction Act extends the premium tax credits (initially enacted as part of the Affordable Care Act) until 2025 and includes a substantial number of provisions relating to green energy. The green energy provisions modify existing tax credits (such as the credit currently available to individuals who purchase electric vehicles), extend existing green energy incentives (including extending the production tax credit in certain circumstances) and add new credits (such as new production and investment tax credits for investments in clean electricity). These provisions are extensive and extraordinarily detailed, and will be the subject of a separate Baker McKenzie client alert.

Members of Congress have now left Washington for the August recess and will not return until after Labor Day. The outlook for additional tax legislation in 2022 is uncertain, although Congress may consider a tax "extenders" bill at the end of the calendar year. The contents of an extenders bill are dependent upon several factors, including the outcome of the mid-term elections in November. However, taxpayers that are concerned about the change under section 174 requiring amortization of R&D expenses should watch the extenders process closely--reinstating immediate expensing for R&D on a retroactive basis for the 2022 tax

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year is likely to be on the short list of items considered for inclusion in a year-end extenders bill.

On August 25, 2022, the White House issued an Executive Order implementing the semiconductor funding in the CHIPS and Science Act. It also released a Fact Sheet related to the Executive Order. The Commerce Department also launched CHIPS.gov, which the agency will use to communicate with the public about CHIPS Program initiatives.

By: Alexandra Minkovich, Washington, DC

Treasury Takes A Baby Step Toward Fixing the Foreign Tax Credit Regulations

Since the final foreign tax credit regulations were issued on December 28, 2021 (the "Final Regulations"), taxpayers and practitioners have expressed broad concerns about their scope and application. See our in- depth special report on the Final Regulations, *Final FTC Regulations Cause Double Taxation – Burden(s) Fall on Taxpayers*. On July 26, 2022, Treasury issued two sets of technical corrections, one set amending the Final Regulations and the other set amending the preamble to the Final Regulations to make conforming changes and minor corrections (collectively, the "Technical Corrections"). The most significant Technical Corrections were to the reattribution payment rules for payments for property and the other to the cost recovery requirement.

Corrections to Reattribution Payment Rules

Prior to the Technical Corrections, the reattribution payment rules did not apply to a disregarded payment received in exchange for property. The regulations had provided that the rules of Treas. Reg. § 1.861-20(d)(2) governed disregarded payments received in exchange for property. Treas. Reg. § 1.861-20(d)(2), in turn, provides that foreign law gain that is subject to foreign tax upon an event that is a disposition of property under foreign law but not a disposition of property under US federal income tax law is assigned to the grouping to which a corresponding US item of gain or loss would be assigned on a taxable disposition of the property under US federal income tax law, without mentioning the reattribution payment rules. The corresponding US item of gain or loss on a taxable disposition of property under US federal income tax law would be the item of US gross income or loss that would have arisen from the disposition, had there been a disposition for US federal tax purposes. It is difficult to believe that Treasury contemplated all along that applying the reattribution payment rules was part of the process of hypothesizing the taxable disposition of the property under US federal income tax law under paragraph (d)(3)(v)(D) and (d)(2), especially since, under the revised regulations, such hypothetical disposition only applies to the extent that the disregarded sale is not treated as a reattribution payment.

The corrections to Treas. Reg. § 1.861-20 provide that the pre-correction rules only apply to the portion of the disregarded payment "other than the portion of the

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disregarded payment that is a reattribution payment." In other words, first the reattribution payment rules apply to disregarded sale of property and then only the amount, if any not treated as a reattribution payment, is subject to the rule that applied prior to the Technical Corrections.

Applying the reattribution payment rules to a disregarded payment of property could have the effect of allocating a foreign tax imposed on a disregarded payment from, say, the tested income group to the foreign base company sales income group. Consider a scenario where a CFC manufactures products through a manufacturing branch in country M which it sells to a low-taxed sales branch of the CFC in country S. The sales branch makes a disregarded payment to the manufacturing branch for the products, and sells the products to third-party customers. The CFC's profits are attributable in part to the sales branch's activities and in part to the manufacturing branch's activities. Suppose that the CFC's profits attributable to the sales branch are foreign branch company sales income and those attributable to its manufacturing are tested income. One might expect that the foreign income tax imposed by country S on the sales branch's profits would be allocated to the foreign base company sales income group and the foreign income tax imposed by country M on the manufacturing branch's profits would be allocated to the tested income group. This, however, does not appear to be how the rules work. Because the CFC has both tested income and foreign base company sales income on the regarded sale, the foreign income tax imposed by country S should be apportioned between the tested income group and the foreign base company sales income group, even though country S may impose the foreign income tax solely on income that is treated as foreign base company sales income. This is because the reattribution rules expressly prevent reattribution of income away from a taxable unit from affecting how the foreign taxes imposed on a taxable unit are allocated and apportioned. *See* Treas. Reg. § 1.861-20(d)(3)(v)(B)(3). Applying the reattribution payment rules to disregarded payments provides an analogous apportionment of the foreign income tax imposed by the manufacturing branch's jurisdiction. That is, if the reattribution payment rules apply to the disregarded payment from the sales branch to the manufacturing branch, the rules appear to assign a part of the disregarded payment to the CFC's foreign base company sales income group within the general category, even though the manufacturing branch would derive tested income on a regarded sale of the property. This is because the reattribution payment rules reattribute part of the CFC's income that is recognized for US tax purposes, i.e., the income derived from the customers, to the manufacturing branch, and the reattributed amount has the same character as the US gross income that is attributed. *See* Treas. Reg. §§ 1.861-20(d)(2)(v)(B)(2), 1.951A-2(c)(7)(ii)(B), 1.904-4(f)(2)(vi)(B)(2). As a consequence, the foreign tax imposed by country M would be apportioned in part to the CFC's foreign base company sales income group and in part to the CFC's tested income group.

Arguably, the rules would have better matched foreign income taxes to the income to which they relate by allocating all of the foreign income tax imposed by country S to foreign base company sales income and all of the foreign income tax imposed by country M to the tested income group. That said, the reattribution rules, as corrected, achieve better parity between the apportionment of the

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foreign income tax on the regarded sale and the apportionment of the foreign income tax on the disregarded sale. If the reattribution rules had not been corrected, it appears that the country S tax would have been apportioned between the foreign base company sales income group and the tested income group, while the country M tax would have been allocated entirely to the tested income group.

The corrections to Treas. Reg. § 1.861-20 also remove disregarded payments for property from the scope of "remittances" and "contributions." That is, no portion of a disregarded payment in exchange for property can be a remittance or contribution. Accordingly, it is unnecessary to consider any reattribution asset in connection with a disregarded payment in exchange for property.

Corrections to Cost Recovery Requirement

Taxpayers and practitioners had voiced concern that the cost recovery requirement, as modified by the Final Regulations, was overly stringent. The cost recovery requirement is one of the four requirements that a foreign tax must now satisfy to qualify as a creditable net income tax (the original three requirements were the realization requirement, the gross receipts requirement, and the cost recovery requirement, and, post-Final Regulations, the latest requirement is the attribution requirement). Under the Final Regulations, Treasury amended the cost recovery requirement to provide that a foreign net income tax must allow recovery of significant costs and expenses, and that costs and expenses "related to capital expenditures, interest, rents, royalties, wages or other payments for services, and research and experimentation are always treated as significant costs and expenses." The cost recovery requirement contained an exception, whereby foreign tax law would be "considered to permit recovery of significant costs and expenses even if recovery of all or a portion of certain costs or expenses is disallowed, if such disallowance is *consistent with the principles under the Internal Revenue Code, including disallowances intended to limit base erosion or profit shifting*." The cost recovery requirement also included several examples of such permitted disallowances -- limitations on interest deductions based on principles similar to those underlying section 163(j), disallowances of interest and royalty deductions in connection with hybrid transactions based on principles similar to those underlying section 267A, and disallowances of certain expenses based on public policy considerations similar to those disallowances contained in section 162. Taxpayers, however, were concerned that each disallowance under foreign law would have to have a corresponding counterpart in the Code disallowing the same deduction, and that the legislative history of the foreign law would have to show that the disallowance was intended to limit base erosion or profit shifting or was based on public policy concerns underlying section 162.

The Technical Corrections have loosened the cost recovery requirement, making it easier to meet. The italicized portion above has been changed to "consistent with any principle underlying the disallowances required under the Internal Revenue Code, including the principles limiting base erosion or profit shifting and

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public policy concerns." While there may be room for interpretation, the amended sentence appears to say that, regardless of the foreign law's intent underlying a disallowance, the foreign tax can meet the cost recovery requirement if the disallowances have the effect of limiting base erosion or profit shifting. This would widen the permissible disallowances to most cross-border payments, which would be consistent with Treasury's reassurances that taxpayers were reading the cost recovery requirement too narrowly. Michael Rapoport, *Treasury Tries to Calm Fears Over Foreign Tax Credit Rules*, Daily Tax Report (July 26, 2022) (Treasury official explained that cost recovery requirement does not require a "one-to-one correspondence" between foreign and US law). The Technical Corrections also generalized the examples of acceptable disallowances to remove references to Code sections 163(j) and 267A, and clarified that a foreign tax can meet the cost recovery requirement even if the foreign tax law significantly delays the recovery of the cost of property until, for example, the taxpayer disposes of the property. Although not found in the text of the Technical Corrections, the IRS publicly clarified that the German license barrier rule should be considered consistent with the principles of base erosion and therefore allowable under the regulations. Andrew Velarde, *IRS Tries to Address Some Concerns Over FTC Cost Recovery Rule*, Tax Notes Today (April 1, 2022).

What Was Not Addressed by the Technical Corrections

The Technical Corrections do not amend the most vexing aspect of the Final Regulations -- the attribution requirement for foreign withholding taxes on royalties, which requires that the royalties be sourced based on the place of use, or the right to use, the intangible property. Unless the foreign withholding tax qualifies as a creditable foreign tax under a treaty to which the United States is a party, the attribution requirement would make many previously creditable foreign withholding taxes on royalties no longer creditable because few countries source royalties based on place of use. We outlined our concerns regarding this requirement in *Final FTC Regulations Cause Double Taxation – Burden(s) Fall on Taxpayers*. Treasury officials have announced that a safe harbor for royalty withholding taxes is forthcoming in the form of a proposed regulation, though the specifics of the safe harbor have not been made public. Andrew Velarde, *Treasury Likely to Issue FTC Regs' Royalty Withholding Carveout*, Tax Notes Today (May 23, 2022). By signalling that the change would be made through a proposed regulation, Treasury likely views the safe harbor as a substantive

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change that it would not have been able to make through the Technical Corrections.

By: Young Choi, San Francisco

Recent IRS Guidance Clarifies the Allocation and Apportionment of Deferred Compensation Expense in the Context of FDII

On May 3, 2022, the IRS issued general legal advice memorandum ("GLAM") 2022-001, which addresses the proper method of allocating and apportioning deferred compensation expense ("DCE") in the context of the foreign derived intangible income ("FDII") regime, where the DCE relates to activities that occurred prior to the effective date of the regime.

Section 861 and the section 861 regulations provide that a taxpayer allocates a deduction to a class of gross income, and then, if necessary, apportions that deduction between the statutory and residual groupings of gross income within that class. The taxpayer must determine the factual relationship of the deduction to income for the taxpayer to properly allocate and apportion the deduction. The taxpayer must allocate the deduction to the relevant class, and must apportion the deduction between the relevant groupings, even if there is no gross income in the class/groupings in the taxable year in which the deduction arises.

As readers will recall, in the 2017 Tax Cuts and Jobs Act ("TCJA"), Congress enacted section 250, which allows a domestic corporation to deduct a fixed percentage of its FDII. Specifically, a taxpayer's FDII deduction is equal to the product of this fixed percentage (currently 37.5%) and the portion of the taxpayer's deduction eligible income ("DEI") equal to the ratio of the taxpayer's foreign-derived deduction eligible income ("FDDEI") over its DEI. DEI is the excess of a domestic corporation's gross income, determined without regard to certain excluded categories of income listed in section 250(b)(3)(A)(i), over the deductions properly allocable to such gross income. FDDEI is generally a subset of DEI that is derived from sales of property to a foreign person for a foreign use or services provided to a person, or with respect to property, located outside of the United States. Gross DEI that is not FDDEI is often referred to as gross residual deduction eligible income ("RDEI"). The FDII regime is effective for taxable years beginning after December 31, 2017.

Treas. Reg. § 1.861-8(f)(1)(vi)(N) establishes section 250(b) as an "operative section" for purposes of apportioning expenses to determine DEI and FDDEI. In other words, for FDII purposes, a taxpayer allocates expenses to a class of gross income and then apportions those expenses among RDEI and FDDEI as the statutory groupings under the section 861 regulations. To the extent expenses relate to income that is excluded from DEI under section 250(b)(3)(A)(i)(I) through (VI), the taxpayer apportions those expenses to the residual grouping (i.e. non-DEI), and those expenses do not offset gross DEI or FDDEI.

In GLAM 2022-001, a calendar-year taxpayer manufactured and sold Product A. Income from sales of Product A was the taxpayer's sole class of gross income.

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Beginning in 2018, the taxpayer claimed the FDII deduction pursuant to section 250.

The taxpayer compensated its employees with restricted stock units ("RSUs"). Each stock-settled RSU represented a promise by the taxpayer to deliver one or more shares of stock to the relevant employee at a future date following a specified vesting condition.

The DCE in GLAM 2022-001 related to RSUs which vested on or after January 1, 2018, but were granted to the taxpayer's employees before January 1, 2018. Thus, the DCE arising from the RSUs could accrue on or after the January 1, 2018 (i.e., after the effective date of the FDII regime), although some or all services to which the RSUs related were performed before January 1, 2018.

The taxpayer took the position that DCE attributable to RSUs that vested post-January 1, 2018 but related to pre-January 1, 2018 services, and which was both allocable to the taxpayer's sole class of gross income (income from sales of Product A) and not definitely related to non-DEI, should nevertheless still be apportioned to the residual grouping (non-DEI) and thus should not reduce RDEI or FDDEI for purposes of computing the taxpayer's section 250 deduction. The taxpayer asserted that this DCE should not be treated as apportionable to income in a statutory grouping under an operative section that did not exist when the relevant employee activities occurred.

The IRS disagreed. The IRS instead concluded that DCE that has a factual relationship to income that falls in the RDEI and FDDEI groupings (i.e., the activities to which the DCE relates were in some way responsible for generating this income) must be apportioned between those groupings, regardless of the fact that the activities themselves occurred before the enactment of FDII. Simply put, from the IRS's perspective, nothing in section 861 or the section 861 regulations changes the year in which an expense accrues. When the expense accrues, the expense must be allocated and apportioned pursuant to the law in force in the accrual year. If the expense has the requisite factual relationship to particular income, the expense effectively attaches to that income; the fact that the governing law categorizes that income in a way that is different from how the law might have categorized that income previously is irrelevant.

By: Ethan Kroll, Los Angeles and Chengwen Tse, San Francisco

Ninth Circuit Rejects Tax Court Decision That Tax Return Was Untimely Filed

In May 2022, the United States Court of Appeals for the Ninth Circuit issued an opinion in *Seaview Trading, LLC v. Commissioner*, holding that the United States Tax Court improperly granted a motion for summary judgment in support of the government's position in a dispute over a three-year statute of limitations period connected to a Final Partnership Administrative Adjustment.

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Statutory Background

At-issue before the Tax Court and the Ninth Circuit were Section 6229(a) and Section 1.603(a)-1(e). Section 6229(a) established that "the period for assessing any tax imposed . . . for a partnership taxable year shall not expire before the date which is 3 years after the later of— (1) the date on which the partnership return for such taxable year was filed, or (2) the last day for filing such return for such year[.]" *Seaview Trading, LLC v. Commissioner*, 34 F.4th 666, 671 (U.S. 9th Cir. 2022). Alternatively, Section 1.603(a)-1(e) "establishes two conditions necessary to comply with the filing command: the tax return must be (1) filed by April 15 and (2) sent to the IRS service center. Under a straightforward reading of § 1.6031(a)-1(e), the only way to comply with its command is to satisfy *both* conditions." *Id.* at 673 n.2.

Tax Court

The Tax Court dispute focused on the statute of limitations period for a Final Partnership Administrative Adjustment ("FPAA") issued in October 2010. Seaview thought that Seaview filed a 2001 Partnership tax return ("Form 1065") in 2002, but the IRS had no record of receiving the 2001 Form 165 from Seaview - despite that Seaview had a certified mail receipt from July 2002 to confirm that Seaview sent the 2001 Form 1065 in July 2002. By contrast, the IRS recognized that Seaview purportedly provided a fax of a copy of Seaview's 2001 Form 1065 in September 2005. Two months earlier, in July 2005, the IRS asked Seaview to send the copy of the 2001 Form 165 to the IRS. The IRS also recognized that Seaview sent a signed copy to an IRS attorney in 2007 of what purportedly was a tax return.

Before the Tax Court, the IRS successfully argued that the copies of what purportedly were tax returns sent in 2005 and 2007 by Seaview were not tax returns in either year. Further, the IRS successfully claimed that the losses and expense amounts provided in the documentation from Seaview in 2005 and 2007 were disallowed. Although Seaview's challenge to the IRS's position regarding the FPAA was unsuccessful before the Tax Court, the parties settled at the Tax Court and Seaview preserved its right to appeal.

Ninth Circuit

Seaview appealed the Tax Court decision to the Ninth Circuit. The Ninth Circuit reviewed the Tax Court's legal conclusions *de novo*. At-issue for the Ninth Circuit was what constituted the "filing" of a tax "return" for the purpose of the statute of limitations under the Tax Code. Seaview's primary argument was that the IRS's FPAA, which resulted in losses as well as expense amounts being disallowed, from 2010 was untimely because Seaview's returns were filed, at the latest, in 2005. Alternatively, the IRS maintained that Seaview's tax returns were never filed despite the apparent efforts of Seaview in 2002, 2005, and 2007.

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In reaching its decision, the Ninth Circuit largely relied on a four factor test which has historically determined what constitutes a "return" under the law in *Beard v. Commissioner*, 82 T.C. 777 (1984). The Ninth Circuit has observed that:

> Although the I.R.C. does not provide a statutory definition of 'return,' the Tax Court developed a widely-accepted interpretation of that term in *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). In order for a document to qualify as a return: '(1) it must purport to be a return; (2) it must be executed under penalty of perjury; (3) it must contain sufficient data to allow calculation of tax; and (4) it must represent an honest and reasonable attempt to satisfy the requirements of the tax law.' … The *Beard* definition is consistent with the purpose of a return, which is not only to get tax information in some form, but 'to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished.'" *United States v. Hatton (In re Hatton)*, 220 F.3d 1057, 1060-61 (9th Cir. 2000).

Further, while discussing Section 1.603(a)-1(e), the Ninth Circuit recognized that Section 1.603(a)-1(e), "doesn't expressly establish how taxpayers are to file delinquent returns. Nothing in the text says that the time and place requirements apply to untimely returns … So, at most, the regulation is silent on filing procedures for late returns." *Seaview Trading, LLC v. Commissioner*, 34 F.4th 666, 672 (U.S. 9th Cir. 2022). The Ninth Circuit continued by setting aside the argument that Seaview sent an untimely 2001 Form 165 in September 2005. Relatedly, the Ninth Circuit provided a helpful analogy to rebut a position made by the dissent. There, the Ninth Circuit states:

> The dissent posits a hypothetical traffic statute, which it claims undermines our plain-meaning interpretation of § 6229(a) … But the hypothetical only proves our point. The dissent's hypothetical statute, unlike § 1.6031(a)-1(e), contains
> two *independent* commands: (1) to stop at all STOP signs, and (2) to obey posted speed limits … Violation of either command violates the law … Indeed, even under the dissent's hypothetical, what is a driver supposed to do if a police officer directs the driver to blow through a STOP sign? Can the driver be cited for complying with the police officer's command rather than stopping at the STOP sign? That's closer to the scenario here—the IRS directed Seaview to submit its partnership return directly to the agent and Seaview complied. But the IRS still argues that Seaview never complied with filing the return." *Seaview Trading, LLC v. Commissioner*, 34 F.4th 666, 673 n.2 (U.S. 9th Cir. 2022).

The dissent responded by asserting:

> The majority attempts to distinguish this hypothetical from § 1.6031(a)-1(e) by arguing that the hypothetical traffic statute 'contains two *independent* commands,' which, to the majority, means that '[v]iolation of either command violates the law,' while § 1.6031(a)-1(e) 'establishes two conditions necessary to comply with the filing command.' Maj. Op. 15 n.2. The majority seems to overlook that the punctuation and structure used in the hypothetical traffic statute are precisely the same as that used in § 1.6031(a)-1(e), which also contains separate, independent time and place commands separated by periods and subsection headings. *See* 26 C.F.R. § 1.6031(a)-1(e). I agree with the majority's recognition that to satisfy § 1.6031(a)-1(e), a partnership must comply with both time and place provisions, Maj. Op. 15 n.2, which is why Seaview failed to file a return in this case, because it complied with neither. The same, of course, is true of the hypothetical traffic statute: to comply with the statute, a driver has to obey speed limits and stop at stop signs. Once again, the majority reasons that because Seaview did not obey the regulation, it is not subject to the regulation. Maj. Op. 15 n.2.
>
> The majority also asks 'what is a driver supposed to do if a police officer directs the driver to blow through a STOP sign? Can the driver be cited for complying with the police officer's command . . . ?' Maj. Op. 15 n.2. The hypothetical question of whether instruction from a police officer might be a defense to traffic liability is, of course, not before us." *Id.* at 684 n. 4.

Nevertheless, the Ninth Circuit maintained that when an IRS revenue agent asked Seaview to send a copy of the 2001 Form 165 in July 2005, the IRS effectively established the filing procedures for the relationship between Seaview and the IRS for this dispute.

The Ninth Circuit reversed the Tax Court's decision that no tax return was filed by Seaview. The Ninth Circuit held that "when (1) an IRS official authorized to obtain and receive delinquent returns informs a partnership that a tax return is missing and requests that tax return, (2) the partnership responds by giving the IRS official the tax return in the manner requested, and (3) the IRS official receives the tax return, the partnership has 'filed' a tax return for purposes of § 6229(a)." *Id* at 669. The Ninth Circuit concluded that those three elements were satisfied with respect to Seaview in this dispute with the IRS. Put differently, element one was satisfied in the July 2005 meeting between the IRS and Seaview after the IRS revenue agent made a request to Seaview for the 2001 Form 1065 in July 2005, element two was satisfied in September 2005 after Seaview sent the fax of the 2001 Form 1065 as requested by the IRS, and element three was satisfied when the IRS received the fax of Seaview's 2001 Form 165. Consequently, the three-year statute of limitations period began in 2005, expired in 2008, and the

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IRS sent an untimely FPAA in 2010 to Seaview as the three-year statute of limitations period under Section 6229(a) had run. Thus, the Ninth Circuit concluded that because Seaview satisfied the *Beard* test and satisfied the elements set forth in its holding, the case was reversed and remanded to the Tax Court.

By: Ronald Beach, Chicago

Treasury Terminates Tax Treaty With Hungary

On July 8, 2022, the US Treasury Department ("Treasury") gave Hungary a six-month advance notice that the United States would terminate the US-Hungary tax treaty (the "Treaty"). Aiming to avoid double taxation and minimize fiscal evasion, the Treaty was ratified by Jimmy Carter on August 7, 1979 and enforced one month later. At that time Hungary's corporate tax rate was as high as 50%. Hungary now offers a 9% corporate tax rate, the lowest across European Union. Treasury concluded that the Treaty no longer provided reciprocal benefits and left the United States with significant loss of potential tax revenues.

Treasury's decision came after the Hungarian government decided to block an EU directive that would impose a 15% global minimum tax on multinational corporations to comply with the OECD's Pillar II global minimum tax regime. The Hungarian government objected on claims that increasing the corporate tax rate on Hungarian companies would damage competitiveness and endanger jobs.

Importantly, the 1979 Treaty lacks an anti-treaty shopping provision, i.e., limitation-on-benefits ("LOB"). This measure is designed to prevent multinational corporations from strategically directing business to a jurisdiction with the intention to take advantage of lower withholding tax rates provided by a tax treaty. An LOB provision was included in the updated version of the Treaty renegotiated in 2010. However, its ratification was held off by Senator Rand Paul. Therefore, Hungary's refusal to implement the global minimum tax could further disadvantage the United States under the Treaty's terms when compared to Hungary, a treaty-shopping jurisdiction.

The Treaty

Under the Treaty, the taxpayers enjoy lower tax rates on certain income, exclusion for certain employment income, as well as relief from double taxation. Several key provisions are briefly reviewed in the text below.

As a preliminary matter, like with other treaties, the double-tax relief granted by the Treaty hinges upon the concept of residency. Generally, a resident is a person taxable under a country's laws based on domicile, residence, citizenship, place of management, or other factors. Thus, the different interpretations of the term between the US and Hungary could result in a person being considered a

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resident of both countries. Under such circumstances, the Treaty provides tie-breaker provisions in the sequence of center of vital interests, habitual abode, nationality, with the last resort to the competent authorities of both countries. However, regardless of the residency status, each country retains the authority of taxing the real property within its borders.

Of particular importance to business entities, Article 5 of the Treaty directs that taxation of business profits of a resident of one country is to be exempted by the other country unless the profits are attributable to a permanent establishment in the other country. Permanent establishment constitutes a fixed place of business through which an entity conducts industrial or commercial activity. An enterprise can also have a permanent establishment in the host country if its employees or other dependent agents located in the said country habitually exercise authority to conclude contracts on behalf and in the name of the enterprise. On the other hand, the term does not include the use of facilities or maintenance of goods for the sole purpose of storage, display, delivery, processing, collecting information, etc.

The Treaty provides for a different treatment of dividends, interest, and royalties, applicable to both individuals and corporations. The withholding tax rates on dividends are set at either 15% or 5%, the latter contingent on the existence of beneficial owners and the former applies to all the remaining cases. A beneficial owner is a corporation resident in the other state who owns, directly or indirectly, at least 10% of the voting stock of the dividend-paying entity in the home state. Article 10 and 11 provide that interest or royalty originating from one country and paid to a resident of the other country is only taxable in the other country. There is no withholding for interest or royalty. For example, in the case of the interest paid to a Hungarian resident by a US company, Hungary shall have the taxation authority.

Lastly, the Treaty covers individual income from various sources. In regard to the personal services performed by an employee in the host country, different from his or her resident country, the income is typically taxed in the host country. By comparison, the residence state has the right to tax an individual's annuities, alimony, child support, and rentals of tangible personal property. Pension rules contain more nuances. Under Article 15, pensions and other similar remuneration beneficially derived by a resident of one country in consideration of past employment shall be taxable only in that county, and social security payments and other public pensions paid by one country to an individual resident of the other country or a US citizen shall be only taxable in the paying country.
Just like many other treaties and notwithstanding any other the provisions, the Treaty contains a "saving clause" (see paragraph 2 of Article 1). The Clause permits each country to reserve the right to tax its own citizens and residents the way that it would in absence of a treaty unless specifically noted otherwise. From a US perspective, its purpose is to prevent a US citizen or resident from using the Treaty for tax-avoidance purpose.

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Consequences of Termination

It is clear that once the Treaty is terminated, anyone with investments or tax exposure connected to Hungary will be affected. The termination will be more significant to Hungarian companies invested in the United States, who will now become subject to a 30% withholding tax on US-source income not effectively connected to US trade or business. From the US perspective, the termination will impact any US residents or US corporations with connections to Hungary.

Such termination will not affect the parties immediately, rather the treaty will cease to have effect on January 1st, 2024. Yet, the treaty terminations may signal growing tension between two countries and therefore deter foreign direct investments upon announcement of the termination. These repercussions are going to be felt before any shift in the economy of two countries, if not already.

From the financial standpoint and as stated above, the termination will cause any US investment income generated by Hungarians to become subject to 30% tax, with no reduction in tax currently available under the Treaty. For individuals, it will also cause full inclusion of their employment income. Finally, there will be no relief from double taxation. Dividends, interest and royalties paid to US corporations are expected to remain tax free as long as there is no withholding tax in Hungary under domestic rules. However, if the Hungarian government decides to introduce withholding taxes on these types of income, there will be no reduction in tax without a treaty. Moreover, US corporations holding shares in Hungarian companies heavily invested in real estate will fall under Hungarian corporate taxation for capital gains realized on the sale of those shares.

Individuals and companies will no longer be able to look into the Treaty. Instead, they will have to look into the domestic law. Unfortunately, many times domestic courts are proved to be slower and biased while a treaty environment is generally perceived as more efficient, providing numerous beneficial international arbitration provisions. When the only reliance is on domestic law, the situation becomes even more complicated if there are significant differences between the laws of two counties, such as the case is with the laws of the US and Hungary.

US persons, who have transactions with or businesses in Hungary should evaluate how the loss of treaty benefits will affect them. Depending on the significance of the potential tax exposure, they may consider limiting if not fully avoiding a Hungarian business, or restructuring the businesses to either avoid or minimize the exposure.

By: Ida Varshavsky and Lily Kang, Zurich

Wayfair: The Sequel

Wayfair is a seminal case in the SALT world. However, its profound effects have brought about some potentially burdensome consequences on taxpayers. In particular, *Wayfair* ushered in a brightline economic nexus test which asked

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whether a tax imposes a "clearly excessive" burden in relation to the putative local benefits. This leads to the obvious question of what is "clearly excessive." In their suit against the City of Lakewood's sales tax, Wayfair contends that Colorado's decentralized system of sales tax collection is clearly excessive because it requires a taxpayer to comply with potentially hundreds of different local jurisdictions, rather than a unitary system of sales tax collection, raising compliance burdens significantly. Local governments in Colorado have recognized the problem and have attempted to put forth solutions, but are they enough? Further, the issue of decentralized tax collections is one that has nationwide implications as Colorado isn't the only state with such a system nor are sales taxes the only ones at stake here.

For more information, please see "*Wayfair: The Sequel*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: David Simon-Fajardo, Chicago

Global Tax Policy Video Series - UK Perspectives on Pillar Two

As discussions on global tax policy evolve, we can expect major economies and their respective tax authorities to weigh in fully, particularly on the implementation of new rules and policies.

In this newest episode of Baker McKenzie's *Global Tax Policy Video Series*, Kate Alexander, Miles Humphries and Nick Evans discuss recent UK perspectives on Pillar Two. They also discuss what UK businesses are doing now to prepare for implementation of the proposed Pillar Two changes, despite a welcome delay to the UK's implementation schedule.

By: Kate Alexander and Nick Evans, London, and Miles Humphrey, New York

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