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Ninth Circuit Holds Mandatory Repatriation Tax is Constitutional

On June 7, 2022, the United States Court of Appeals for the Ninth Circuit affirmed a district court judgment of dismissal and held that Code Section 965's transition tax (referred to by the court as the "Mandatory Repatriation Tax" or "MRT") did not violate the Constitution's Apportionment Clause or the Fifth Amendment's Due Process Clause.

Charles and Kathleen Moore (the "Taxpayers") invested in KisanKraft, a corporation, which supplied tools to farmers in India. The Taxpayers invested $40,000 in return for a combined 11% ownership interest in KisanKraft. The company, which was headquartered and incorporated in India, is a controlled foreign corporation ("CFC"). A CFC is a corporation organized outside of the United States that is owned more than 50% by US persons. Since the company's formation, KisanKraft was managed from India. While the company was profitable every year, it had never distributed earnings to its shareholders. Instead, it reinvested all earnings back into the company. Because the company did not distribute its earnings to shareholders and instead reinvested them (and the earnings were not previously subject to any specific Subpart F inclusion), the Taxpayers had no US tax liability on their earnings prior to 2017.

In 2018, the Taxpayers learned about their tax obligation under the MRT. This tax was added as part of the 2017 Tax Cuts and Jobs Act ("TCJA"), which overhauled US corporate taxation with the intent of shifting it from a worldwide system to a partially territorial one (with many exceptions). Thus, for example, dividends paid by CFCs post-TCJA to US persons are generally eligible for a participation exemption. To facilitate this transition, Congress established a one-time MRT on accumulated, or undistributed, earnings of CFCs.

According to their calculations, the Taxpayers found that, based on KisanKraft's financial statements, their pro rata share of KisanKraft's retained earnings, or the accumulated portion of the business's profits that were not distributed as dividends, were $508,000. They would have to include an additional $132,512 in taxable income under the MRT, and their tax liability for 2017 would increase by nearly $15,000 because of the tax. The Taxpayers initially filed an amended return and paid the additional liability, but later filed a second amended return, claiming a refund for the additional liability and challenging the constitutionality of the MRT.

The government subsequently filed a motion to dismiss for failure to state a claim. It argued that the Taxpayers' claims failed because the MRT is not a direct tax and thus their Apportionment Clause claim should be denied. Further, it argued that the MRT was not retroactive and thus their Fifth Amendment claim should be denied. The district court granted the government's motion to dismiss, finding that the Taxpayers did not provide any grounds for which the MRT was unconstitutional. The Taxpayers appealed to the United States Court of Appeals for the Ninth Circuit.

Ninth Circuit Holds "The MRT Does Not Violate The Apportionment Clause"

The first issue the Ninth Circuit addressed was whether the MRT violated the Constitution's Apportionment Clause. The court held the MRT was consistent with the Constitution because the government has the general power to lay and collect taxes. The Apportionment Clause requires that any "direct Tax" levied by the government must be apportioned (or divided) so each state pays its pro rata share of tax. *Moore*, No. 20-36122 at 9 (citing *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 567 U.S. 219, 533-534 (2012)). The proration of a direct tax for a given state must be based on its relative population to that of the United States.

The Taxpayers argued that the MRT is an unapportioned direct tax. They contended that the MRT is a tax on personal property because it is assessed on a shareholder's retained earnings, or ownership interest, in a CFC, and not on the income of the CFC itself. Because the MRT fails to apportion itself among the states, the Taxpayers claimed that it is constitutionally defective under the Apportionment Clause. Alternatively, the Taxpayers argued that the court should rely on their interpretation of two foundational income tax cases, *Eisner v. Macomber* and *Comm'r v. Glenshaw Glass*, such that the cases "require income to be realized before it can be taxed." *Moore*, No. 20-36122 at 13 (citing *Macomber*, 252 U.S. 189, 219 (1920); *Glenshaw*, 348 U.S. 426, 431 (1955)).

Responding to the Apportionment Clause argument, the court noted that the Sixteenth Amendment exempts from apportionment the vague and "expansive category of 'incomes from whatever source derived.'" *Moore*, No. 20-36122 at 10 (quoting U.S. Const. amend. XVI). Despite the difficulty of "categorically defining everything that constitutes income," the court noted "the concept of income is a flexible one." *Moore*, No. 20-36122 at 10 (quoting *United States v. James*, 333 F.2d 748, 753 (9th Cir. 1964)). In essence, the court suggested the MRT should not be strictly construed as an apportioned direct tax given the "wide scope" courts have to define income. *Id.* To support its holding, the court named previous decisions which found taxes similar to the MRT to be constitutional. The court cited the following cases as precedential: *Eder v. Commissioner of Internal Revenue*, 138 F.2d 27, 28-29 (2d Cir. 1943) (holding the inclusion of foreign corporate income under a statute predating Subpart F to be valid); *Whitlock's Est. v. Comm.'r*, 59 T.C. 490, 508 (1972), *aff'd in part, rev'd in part*, 494 F.2d 1297, 1298-99, 1301 (10th Cir. 1974) (holding several pre-MRT provisions of Subpart F to be valid despite constitutional challenges); *Garlock Inc. v. Comm'r*, 489 F.2d 197, 202 (2d Cir 1973) (affirming Tax Court's ruling that the Subpart F income of a CFC was attributable to its shareholders regardless of whether it was distributed). *Moore*, No. 20-36122 at 10.

The court also explained that the realization of income does not determine the constitutionality of a tax. The court made this assertion in response to the Taxpayers' argument that, under the Sixteenth Amendment, the MRT "cannot be a tax on 'income'" because it is "not triggered by any realization event by which 'income' is 'derived' by the taxpayer." Pls.' Resp. In Opp'n To Mot. To Dismiss And Cross-mot. For Summ. J., 14-15, *Moore v. United States*, Civil Action No. 2:19-cv-01539 JCC (W.D. Wash. 2020). The court found it significant to note the "fact that distribution of income is prevented by operation of law, or by agreement among private parties is no bar to its taxability." *Moore*, No. 20-36122 at 11 (citing *Eder*, 138 F.2d at 28). Pointedly, it stated that the general rule of taxing income only once it is realized is a rule that exists solely for "administrative convenience." *Moore*, No. 20-36122 at 11 (citing *Helvering v. Enright's Est.*, 312 U.S. 636, 641 (1941)). The court further explained that "[w]hat constitutes gain is also broadly construed," in response to the Taxpayers' argument that "a CFC's retained earnings are not its shareholder's 'income' for purposes of the Sixteenth Amendment." *Moore*, No. 20-36122 at 11; Pls.' Resp. In Opp'n To Mot. To Dismiss And Cross-mot. For Summ. J., 16, *Moore*, Civil Action No. 2:19-cv-01539 JCC (W.D. Wash. 2020). By way of example, the court cited the following as precedential: *Helvering v. Bruun*, 309 U.S. 461, 469 (1940) (holding a taxable gain should be recognized in a lessee's improvements to property when the lessor regained possession of the land); *Vukasovich, Inc. v. Comm'r*, 790 F.2d 1904, 1415 (9th Cir. 1986) (holding the cancellation of indebtedness also created a taxable gain). *Moore*, No. 20-36122 at 12.

Lastly, the court held that Congress is not barred from setting aside a corporation's structure to tax its shareholders, in response to the Taxpayers' argument that *Macomber* stood for the notion that "the Sixteenth Amendment did not permit . . . a corporation's earnings [to be] deemed its owner's income unless it has been realized by them." *Moore*, No. 20-36122 at 12; Pls.' Resp. In Opp'n To Mot. To Dismiss And Cross-mot. For Summ. J., 16-17, *Moore*, Civil Action No. 2:19-cv-01539 JCC (W.D. Wash. 2020). Noting that there was no dispute in the facts that KisanKraft "earned significant income," the court pointed out that all tax due on their pro-rata share of the CFC was deferred until the MRT went into effect. *Moore*, No. 20-36122 at 12. Ultimately, the court held that Subpart F only applies to 10% or greater shareholders in CFCs and that the MRT "builds upon [a] preexisting tax liability attributing a CFC's income to its shareholders." *Id.* The court then zeroed in on the fact that 10% or greater shareholders "have some ability to control distribution." *Id.*

Ninth Circuit Holds "The MRT Does Not Violate the Fifth Amendment's Due Process Clause"

The second argument the court considered was whether the MRT violated the Fifth Amendment's Due Process Clause. To this point, the Taxpayers argued that, because the MRT was a retroactive and wholly new, one-time tax, there was no governing precedent to support the enactment of it; and the MRT could not be constitutionally implemented. The Taxpayers argued that the MRT is a wholly new tax because they had no reason to expect that the United States would tax them for foreign-corporation income that is not their own income in any aspect and has never previously been subject to US taxation. Pls.' Resp. In Opp'n To Mot. To Dismiss And Cross-mot. For Summ. J., 22, *Moore*, Civil Action No. 2:19-cv-01539 JCC (W.D. Wash. 2020) (citing *Quarty v. United States*, 170 F.3d 961, 967 (9th Cir. 1999) (defining "wholly new tax" as a tax where "the taxpayer has no reason to suppose that any transactions of the sort will be taxed at all")).

The court rejected this argument, and held that the MRT did not violate the Fifth Amendment's Due Process Clause. While the court assumed, without deciding, that the MRT was retroactive, it pushed back on the argument that the MRT was a "wholly new tax." To the contrary, it found that it was not a wholly new tax because prior to the MRT, US shareholders were taxed on CFC earnings when they were distributed (or when the CFC's earnings were subject to certain Subpart F provisions). The court stated that reliance alone is insufficient to establish a constitutional violation, and that "tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." *Moore*, No. 20-36122 at 16.

Instead, the court considered whether the MRT was constitutional based on the test set forth in *United States v. Carlton*, 512 U.S. 26 (1994). There, the United States Supreme Court held that, to analyze a due process challenge to retroactive tax legislation, the court should consider whether the retroactive application itself serves a legitimate purpose by rational means. *Id.* at 30. Ultimately, the court found that the MRT did serve a legitimate purpose of taxing deferred undistributed earnings. The MRT accomplishes this purpose by accelerating the effective repatriation date of undistributed CFC earnings to a date following the TCJA. Therefore, the court held that the MRT did not violate the Fifth Amendment's Due Process Clause.

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Step Transaction - Did the Court of Federal Claims Get It Wrong?

In *GSS Holdings Inc. v. United States*, 154 Fed. Cl. 481 (2021), the Court of Federal Claims applied a combination of substance over form and the step transaction doctrines to link together two transactions originally agreed to by unrelated parties to address an issue raised by Canadian banking regulations. Although the court's opinion focuses primarily on the step transaction doctrine, the court asserts that the question should be viewed "under the larger tax law concept of 'substance over form.'" This decision appears to blend different substance over form doctrines and, in the process, creates uncertainty for taxpayers regarding the proper application of the step transaction doctrine.

Background

GSS Holdings ("GSS") brought a tax refund action in the Court of Federal Claims requesting an allowance of a loss of $22.54 million claimed under section 165, which the IRS previously disallowed. GSS claimed the loss on its 2011 return and carried it back to 2009.

In disallowing the loss, the IRS asserted that it was not an ordinary business loss under section 165 but instead was incurred as part of a series of transactions that resulted in a sale of capital assets between related parties. Thus, it was a capital loss that should be disallowed under the related party rules of section 707(b)(1). The Court affirmed the IRS adjustment, and GSS appealed the case to the Federal Circuit.

The entity that incurred the $22 million dollar loss in the first instance was Liberty Street Funding LLC ("Liberty"). Liberty was a commercial paper conduit, a financial vehicle that made investments funded by the issuance of short-term notes (commercial paper). Although Liberty was a wholly owned subsidiary of GSS, GSS had a nominal equity interest in Liberty totaling only $25,000. GSS also did not have decision-making authority over Liberty's operations, which instead were managed by the Bank of Nova Scotia ("BNS"), a Canadian chartered bank that operated as Liberty's administrator. As administrator, BNS managed Liberty's investments in exchange for a fee. One of BNS's responsibilities was to arrange for Liberty to enter into Liquidity Asset Purchase Agreements ("LAPAs") with banks to shift Liberty's risks to the relevant banks. Liberty would enter into an LAPA for every package of longer-term investments that it purchased. The LAPA ensured liquidity for Liberty by enabling Liberty to put the relevant investment package to a counterparty at a preset price, regardless of the market value of the investments. Liberty paid a liquidity fee to the counterparty for the assumption of this risk. In addition to being Liberty's administrator, BNS was also the counterparty on over 95% of Liberty's LAPAs, including the one at issue in the *GSS Holdings* case.

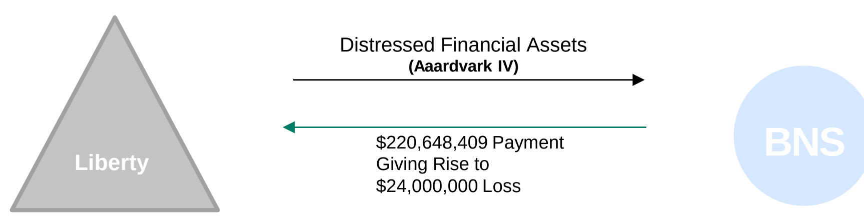
In 2006, Liberty entered into a LAPA with BNS. Because BNS was also the administrator of Liberty and primary beneficiary of Liberty's operations, BNS reported Liberty's activities on BNS's consolidated balance sheet. In 2007, a Canadian banking regulation (Basel II) took effect with potential adverse consequences to BNS. BNS wanted to avoid these adverse consequences, so BNS decided to deconsolidate from Liberty. To achieve this deconsolidation, Liberty had to shift a sufficient amount of benefit and risk away from BNS. To do so, in April 2007, Liberty entered into the First Loss Reserve Note ("FLN") with Reconnaissance Investors, LLC ("Reconnaissance"), an unrelated party, and amended its administration agreement with BNS. Pursuant to the terms of the FLN, Reconnaissance loaned money to Liberty in amounts needed to compensate each LAPA counterparty for the losses that it incurred as a result of purchasing distressed assets under the applicable LAPA. Reconnaissance received interest payments in return for the loan proceeds. Under the revised administration agreement, BNS, as administrator, was to withdraw funds from Liberty's FLN Reserve Account in the amount of the losses at issue and pay them to the LAPA counterparty. This arrangement was designed to shift the risks previously borne by BNS, as LAPA counterparty to 95% of Liberty's LAPAs, to Reconnaissance. As a result of terms of the FLN, and the resulting shifting of risks, the First Loss Note was treated as a partnership interest in Liberty for US federal income tax purposes. Thus, Reconnaissance was treated as a partner of Liberty, together with GSS, during the period in which it was a party to the FLN.

The FLN remained in place with Reconnaissance as creditor until 2011, when BNS adopted the International Financial Reporting Standards ("IFRS"), and this adoption required BNS and Liberty to reconsolidate. As a result, the structure in place with Reconnaissance became unnecessary. Scotiabank (Ireland) Limited ("Scotiabank"), a wholly owned subsidiary of BNS, acquired the FLN on December 29, 2011 to internalize the high interest rates paid to Reconnaissance. When Scotiabank became creditor of the First Loss Note, Scotiabank became a partner in Liberty for US federal income tax purposes and Reconnaissance ceased to be one. BNS and Liberty also became related parties for tax purposes.

On December 30, 2011, Liberty exercised an LAPA related to an investment known as "Aardvark IV." This LAPA, originally put in place in September of 2006, required BNS to purchase the Aardvark IV assets from Liberty at a value equal to Liberty's basis in the assets. Exercise of this LAPA resulted in a loss to BNS of $24 million, which triggered a loan by Scotiabank to Liberty's FLN Reserve Account in the same amount. This amount was then transferred to BNS as counterparty to the LAPA pursuant to the revised administration agreement. The amount claimed on GSS's return had been reduced by $1.45 million in insurance proceeds that arose from the same event, resulting in the disputed $22.54 million amount noted above. The LAPA and FLN transactions are summarized in the diagrams below.

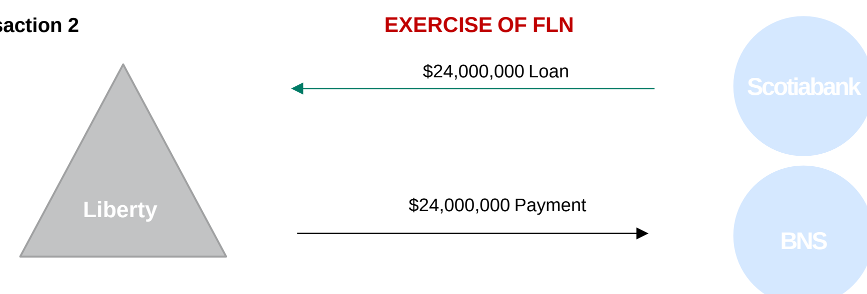
Transaction 1

EXERCISE OF LAPA



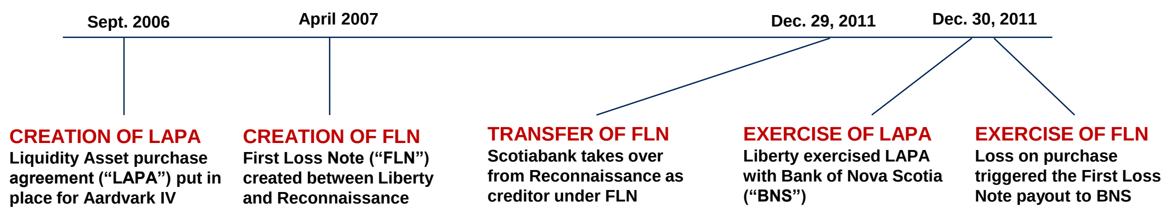
Transaction 2

EXERCISE OF FLN



Below is a timeline of the events as they occurred:

Timeline of Events



Analysis

The IRS put forward two arguments in support of its position to treat the LAPA and FLN as a single, combined transaction: (1) Liberty netted the results of the LAPA and FLN transactions in its tax filings, so GSS should be bound by this characterization under *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967); and (2) under the step transaction doctrine, the LAPA and FLN transactions should be viewed as inextricably linked and stepped together. The court rejected the IRS's *Danielson* argument regarding characterization but agreed that the two transactions should be analyzed together under substance over form principles.

Although the court asserted at the outset of the opinion that the transaction should be analyzed under the broad tax concept of "substance over form," most of the court's opinion focused on the application of the "end result" test under the step transaction doctrine. The end result test asks if a series of transactions are independent, or if they are actually components of a single transaction that was intended from the *outset* with the purpose of reaching an ultimate result. GSS asserted that the "end results" test was not applicable because (1) the parties created the FLN for legitimate business reasons and (2) it could not have intended to make the FLN payment because Liberty never intended to invest in declining assets. The court did not appear to question the business reasons for establishing the LAPAs. The court also did not question Liberty's decision to put the FLN in place and acknowledged the stated business reasons for Scotiabank to acquire the FLN (i.e., to internalize the high interest expense under the agreement with Reconnaissance and because the original purpose of the note no longer existed under new accounting standards). Instead, the court determined that GSS focused on the wrong transaction. The relevant event should not be the creation of the FLN in 2007 but the payment out of it to BNS in 2011. The intended purpose of the FLN was to work in tandem with the LAPA and compensate losses stemming from it. Consequently, the court held that these transactions were inextricably linked and should be considered together, resulting in the characterization of the FLN payment as part of a capital sale.

Given that the "end results" test focuses on the intention of the parties at the *outset* of the transaction, the court's focus on events occurring in 2011 seems misplaced. However, it is difficult to deny that, at the time the FLN was executed, payments under this agreement were intended to be made in conjunction with a capital sale. Indeed, the Aardvark IV LAPA was already in place at the time that the original FLN was put into place in 2007, so the parties likely anticipated the possibility that this LAPA might be exercised and might trigger a corresponding payment under the FLN. The question is whether this should be enough to apply the "end results" test when there are business reasons for the structure of the transaction and there does not appear to be any evidence of tax avoidance on the part of the taxpayer. Circuits have been split on this question, but the Federal Circuit in *Falconwood Corp. v. U.S.*, 422 F.3d 1339, 1349 (Fed. Cir. 2005) held that the step transaction doctrine did not apply to step together transactions that the taxpayer performed for independent business purposes.

The court in *GSS Holdings* seeks to distinguish the *GSS Holdings* facts from those in *Falconwood* but does so unconvincingly in a footnote. It will be interesting to see how the Federal Circuit decides on appeal, as it seems that this decision will hinge largely on how much weight the court gives to business purpose in determining whether the step transaction doctrine applies.

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Grade the OECD's Progress Report on Amount A

After several public consultations on individual elements of Pillar One's Amount A, the OECD Secretariat has now released a consolidated version of the draft operative provisions on Amount A in its Progress Report dated 11 July 2022. The Progress Report contains a mix of previously published and unchanged provisions, previously published and amended provisions, and newly published provisions. The newly published provisions include model rules for three building blocks of Amount A, namely:

- Segmentation,
- Marketing and Distribution Profits Safe Harbor, and
- Elimination of Double Taxation.

To read more about the particularly noteworthy changes to previously published and amended provisions and the newly published provisions, see Baker McKenzie's Client Alert, *Progress Report on Amount A published*.

The OECD welcomes public comments on the Progress Report no later than 19 August 2022.

Further work on provisions dealing with withholding taxes, unilateral measures (such as digital services taxes) and administration, as well as tax certainty processes, is underway but has not been presented yet.

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These building blocks are expected to be released for public comments before October 2022, according to an updated timeline published in the Progress Report.

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