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Tax News and Developments
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Fed-Ex v. United States

On March 31, 2023, the United States District Court for the Western District of Tennessee granted FedEx's motion for partial summary judgment and invalidated Treas. Reg. § 1.965-5(c)(1)(ii), which purported to disallow credits for foreign taxes paid or accrued associated with Offset Earnings, as described below. Order, *FedEx Corp. & Subs. v. United States*, 20-cv-2794 (W.D. Tenn. Mar. 31, 2023). The court invalidated the foregoing regulation (the "Final Rule") as contrary to statute under *Chevron* Step One and further held that the government's interpretation of the relevant statutory text was unreasonable under *Chevron* Step Two.

Prior to the 2017 Tax Cuts and Jobs Act (TJCA), Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017), the US employed a "worldwide" system of taxation that taxed all income earned by US citizens and corporations whether it was generated domestically or abroad. In 2017, Congress passed the TCJA which replaced the "worldwide" system of taxation with a "territorial" system of taxation. To facilitate the change in tax law, Congress imposed a one-time "transition tax" under section 965 on deferred foreign earnings. In determining the transition tax, Congress recognized that many multinational corporations had foreign subsidiaries that lost money for years. Thus, under section 965(b), Congress allowed multinational corporations to offset or net the earnings of historically profitable foreign corporations with the losses of historically loss-making controlled foreign corporations. The court defined the portion of earnings from profitable foreign corporations that are offset by losses from other foreign corporations as "Offset Earnings." The net amount of deferred earnings (the section 965(a) inclusion) was included in income under section 951. The Offset Earnings were treated as included in income only "[f]or purposes of applying section 959." Under section 965(b)(1), Offset Earnings are never actually included in income under section 951.

The Department of Treasury promulgated Treas. Reg. § 1.965-5(c)(1)(ii) (the "Final Rule"), which provides in pertinent part that "[n]o credit is allowed under section 960(a)(3) or any other section for foreign income taxes that would have been deemed paid under section 960(a)(1) with respect to the portion of a section 965(a) earnings amount that is reduced under § 1.965-1(b)(2) or § 1.965-8(b) [i.e., for foreign taxes on Offset Earnings]."

FedEx initiated a refund suit and challenged the validity of the Final Rule, which required the court to interpret the statute under the two-step *Chevron* framework. *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Under *Chevron*, the court first asks whether Congress has directly spoken to the precise question at issue (*Chevron* Step One). If a court — using all of the ordinary tools of statutory construction to interpret the statute and without providing any deference to the agency's views — determines that the statute is unambiguous under *Chevron* Step One, the inquiry must end and the statute controls. If a statute is ambiguous, the court proceeds to *Chevron* Step Two, which asks whether the agency's regulation is a permissible interpretation of the statute. In *FedEx*, the Court focused its *Chevron* Step One analysis on the limiting language in section 965(b)(4)(A). The court stated that the ordinary and common meaning of section 965(b)(4)(A) was to command that Offset Earnings be treated as included in income only "[f]or purposes of applying section 959." Had Congress intended section 965(b)(4)(A) to apply more broadly, it could have done so.

The court considered the government's "dual and self-contradictory" argument with respect to Offset Earnings and section 960. According to the government, because Offset Earnings were deemed included in income, the foreign taxes paid on Offset Earnings were deemed to have already been paid under section 960(a)(1), such that section 960(a)(2) disallowed a second credit. But, as the court noted, the government did not previously provide a credit for foreign taxes paid on Offset Earnings under section 960(a)(1). That is because Offset Earnings were included in income only "[f]or purposes of applying section 959" and were not actually included in income under section 951 by reason of section 965(b)(1), so section 960(a)(1) did not provide a credit. Because section 959 classified Offset Earnings as previously taxed earnings and profits, foreign taxes paid or accrued on those earnings were creditable under section 960(a)(3) when distributed back to the United States. According to the court:

> FedEx's account is simpler and more convincing: its Offset Earnings, when distributed, were "excluded from gross income under section 959(a)," and the foreign taxes paid on Offset Earnings were never previously "deemed paid . . . under" section 960(a)(1). 26 U.S.C. § 960(a)(3) (2016). Under these straightforward and unambiguous statutory terms, FedEx is entitled to foreign tax credits on its Offset Earnings under section 960(a)(3).

The court acknowledged the government's policy arguments but made clear that because the statute was unambiguous, it could not "consider extra-textual indicators of congressional intent, such as legislative history or general considerations of policy, at *Chevron* step one." Further, the court noted that Congress may well have intended to grant foreign tax credits on Offset Earnings given Congress's policy of encouraging the repatriation of foreign earnings.

In sum, the court held that Final Rule was invalid under *Chevron* Step One as the Final Rule contradicted the unambiguous statute. The court also stated that even if the statutory text was ambiguous, the regulation was still invalid under *Chevron* Step Two because the government's interpretation of the statute was unreasonable.

By: Cameron Reilly, Chicago

Upcoming Tax Events

EMEA Tax Upcoming Events

► Various Dates

AAPI Heritage Month Panel

Webinar
► May 31, 2023

Latin American Tax Conference 2023

Miami, FL
► June 5-7, 2023

Global Tax Planning & Transactions Workshop

London and New York
► June 13, 2023

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

Supreme Court Sustains IRS's Power to Issue No-Notice Summons, but Indicates that Power Is Not Unlimited

As discussed in our previous article, *Polselli v. IRS* involved a challenge to the scope of the IRS's authority to issue "no-notice" summonses under section 7609(c)(2)(D)(i). While section 7609 generally requires the IRS to provide notice to any person who is identified in a summons, section 7609(c)(2)(D)(i) set forth an exception for summonses issued "in aid of the collection of…an assessment made or judgment rendered against the person with respect to whose liability the summons is issued." In *Polselli*, the Supreme Court rejected petitioners' argument that this exception should be limited to cases in which the delinquent taxpayer himself holds a "legal interest" in the summonsed records.

The Court unanimously joined Chief Justice Roberts' majority opinion, which held that plain language of section 7609(c)(2)(D)(i) did not support petitioners' proposed legal-interest test. The absence of an express reference to "legal interest" in the words of the statute was an especially compelling point, in the Court's view, given that an adjacent Code section — section 7610, dealing with reimbursement of costs for summons compliance — specifically sets forth an exception for the costs of producing records in which the delinquent taxpayer "has a proprietary interest." The majority also concluded that the petitioners' arguments for implying a legal-interest limitation in section 7609(c)(2)(D)(i) were unconvincing. Chief Justice Roberts wrote that the phrase "in aid of" ordinarily means "to help" or "assist," and could not reasonably be interpreted to require — as petitioners urged — that the summons "directly advance" collection by seeking records of collectible funds. The Court also rejected petitioners' argument that a broad interpretation of clause (i) in section 7609(c)(2)(D) rendered clause (ii) "superfluous," agreeing with the IRS that these provisions apply in different contexts and for two different types of liabilities.

While the Court ultimately rejected petitioners' legal-interest test, it was careful to frame its decision in the narrowest possible terms. Specifically, Chief Justice Roberts wrote that the Court's opinion did not render any opinion "on the precise bounds of the phrase 'in aid of the collection,'" suggesting, in effect, that the Court remains open to challenges in future cases where a summons fails to seriously advance collection of a delinquent taxpayer's liability. Paying credence to concerns raised by petitioners (and numerous amici) about unwarranted invasions of privacy, the Chief Justice wrote further: "We do not dismiss any apprehension about the scope of the IRS's authority to issue summonses. As we have said, 'the authority vested in tax collectors may be abused, as all power is subject to abuse.'" Slip op. at 12 (quoting *United States v. Bisceglia*, 420 U.S. 141, 146 (1976)).

A concurring opinion authored by Justice Jackson (joined by Justice Gorsuch) gave fuller voice to the "apprehension" alluded to by the majority. While she agreed with the majority's specific holding that section 7609(c)(2)(D)(i) does not impose a legal-interest limitation, Justice Jackson wrote that her understanding of section 7609's purpose would have led her to reach a different result if the case were not decided on such a narrow basis. The concurrence emphasized that the "default rule" under section 7609 is to provide notice, and so the exception set forth in section 7609(c)(2)(D)(i) requires a balancing of interests, between the government's interest in collection, on the one hand, and the individual's interest in notice and an opportunity for judicial review, on the other. Moreover, Justice Jackson explained that "the statute's balancing of interests indicates that Congress did not give the IRS a blank check…to do with as it will in the collection arena." With that in mind, she concluded that the IRS's decision to utilize section 7609(c)(2)(D)(i) in the petitioners' case was a step too far: "[A]llowing the agency to sidestep oversight of its broad summons power by not providing notice in these kinds of situations undermines the important aims of the default-notice system."

In short, while *Polselli* represents a significant victory for the IRS, the decision, taken as a whole, signals that the Court does not believe the agency's power to issue no-notice summons "in aid of collection" is unbounded. Justice Jackson's concurrence, in particular, makes plain that she would interpret the statute to require something like a balancing test in all cases moving forward. Only time will tell whether the agency heeds this guidance and implements a more conservative approach in future cases seeking to compel the production of records from innocent third parties.

By: Daniel Rosen and Eric Aberg, New York

Green Projects Get Needed Guidance on Domestic Content Bonus Credit

Released May 12, 2023, Notice 2023-38 (the "Notice") provides interim guidance on the "domestic content" bonus tax credit amounts available for facilities that generate electricity from renewable resources (e.g., wind and solar facilities) and certain energy storage property. The "domestic content" bonus incentivizes owners of green energy projects to utilize domestically-manufactured materials and components (including steel, iron, and "manufactured products") by offering them an additional incentive in the form of an increased tax credit for doing so.

Legislative Background

The Inflation Reduction Act (IRA) amended sections 45 and 48 and added new sections 45Y and 48E. The IRA also provides for several "bonus credits" to encourage certain taxpayer investments, including a "domestic content bonus credit," which increases the amount of tax credits for which a qualifying facility is eligible if certain requirements are met for US-sourced components.

Section 45 provides taxpayers with a production tax credit for electricity produced by a qualified renewable energy facility owned by the taxpayer and sold to an unrelated party. The IRA amended section 45 to increase the amount of the section 45 credit by 10% if the qualified facility can show that all steel, iron, and "manufactured products" which are components of such facility upon completion of construction were produced in the United States (the "domestic content requirement"). For purposes of the domestic content requirement, a manufactured product is deemed to be produced in the United States if not less than an "adjusted percentage" of the total costs of the manufactured products of the facility are attributable to manufactured products (including components) which are mined, produced, or manufactured in the United States.

Section 45Y provides for a production tax credit for clean electricity generated by qualified facilities placed into service after December 31, 2024. Under section 45Y, qualification of the tax credit is technology neutral, meaning that a facility qualifies based on the lack of greenhouse gas emissions associated with the electricity generation process, rather than the specific technology used to generate power. The section 45Y credit amount is, however, likewise increased by 10% for qualified facilities that meet the domestic content requirement.

Section 48 provides a taxpayer with an investment tax credit equal to a percentage of the basis of qualifying property placed into service by the taxpayer during the taxable year. The IRA amended section 48 to increase the percentage used to calculate the section 48 credit for energy projects which meet the domestic content requirement.

Section 48E provides for a technology-neutral investment tax credit for qualified clean energy production facilities or energy storage property placed into service after December 31, 2024. This amount is increased for qualifying property which meet the domestic content requirement.

General Definitions

The Notice provides interim guidance on whether a credit-eligible facility, referred to as an "applicable project," meets the domestic content requirement and thereby qualifies for the domestic content bonus credit. It clarifies how "applicable project components." which are articles, materials, or supplies, whether manufactured or unmanufactured, that are directly incorporated into an Applicable Project are taken into account for purposes of this determination. Applicable project components are categorized as either (i) steel or iron that serves a structural function, or "manufactured products" that comprise the project. Articles, materials, or supplies, whether manufactured or unmanufactured, that are directly incorporated into an applicable project component that is a "manufactured product" are referred to as "manufactured product components."

Steel or Iron Requirement

For an applicable project to meet the domestic content requirement, all steel or iron used therein must be domestically produced. This means that all manufacturing processes with respect to applicable project components that serve a structural function and that made of steel or iron must take place in the United States. The sole exception to this rule is for metallurgical processes involving the refinement of steel additives. The steel or iron requirement does not apply to steel or iron used in manufactured product components or subcomponents of manufactured product components, such as nuts, bolts, screws, washers, cabinets, covers, shelves, clamps, fittings, sleeves, adapters, tie wire, spacers, door hinges, and similar items made primary of steel or iron but are not structural in function.

Manufactured Products Requirement

In addition, in order for an applicable process to qualify for the domestic content bonus, manufactured products that are applicable project components must be produced in the United States or deemed to be produced in the United States. A manufactured product is deemed produced in the United States if all of the manufacturing processes for the manufactured product take places in the United States and all of the manufactured product components of the manufactured product are of US origins. A manufactured product component is considered to be of US origin if it is manufactured in the United States, regardless of the origin of its subcomponents.

All applicable project components that are manufactured products are deemed to be produced in the United States if the “adjusted percentage rule” is satisfied. For purposes of the adjusted percentage rule, a percentage is calculated by dividing the “domestic manufactured products and components cost” by the “total manufactured products” cost.

The domestic manufactured products and components cost is the sum of the costs of an applicable project’s (1) US manufactured products that are applicable project components and (2) manufactured product components of non-US manufactured products that are applicable project components if the manufactured product components themselves are mined, produced, or manufactured in the United States.

The total manufactured products cost is the sum of the costs of each applicable project component that is a manufactured product.

If the percentage calculated as described above is equal to or greater than the “adjusted percentage,” the manufactured products which are applicable project components are deemed to be manufactured domestically for purposes of the bonus credit. The adjusted percentage is 40% for qualified facilities the construction of which begins before January 1, 2025, and incrementally increases to 55% over time. In the case of offshore wind facilities, the adjusted percentage is 20% for facilities the construction of which begins before January 1, 2025, incrementally increasing to 55%.

Safe Harbor

The Notice also provides a list of applicable project components in utility-scale photovoltaic systems, land-based wind facilities, offshore wind facilities, and battery energy storage systems and classifies these applicable project components into steel/iron structural elements and manufactured products. These applicable project components must meet the applicable steel or iron test or manufactured products test in order to meet the domestic content requirement.

Retrofitted Projects

The Notice provides guidance on how retrofitted projects can qualify for the new credits and the domestic content bonus credits even though they may contain used property. Generally, a retrofitted project qualifies as newly placed in service, and therefore as qualifying for tax credits in the same manner as a newly-constructed project, if the fair market value of the used property comprising the retrofitted project does not exceed 20% of the applicable project's total value, calculated by adding the cost of new property to the value of the old property. A retrofitted project placed in service after December 31, 2022 that meets the foregoing test will also be eligible for the domestic content bonus credit amount if the new property used to retrofit that project meets the domestic content requirement.

What's Next

Treasury and the IRS intend to issue proposed regulations consistent with the Notice that will apply to tax years ending after May 12, 2023. Taxpayers may rely on the interim guidance until 90 days after proposed regulations are published. While the IRS and Treasury have not established a formal consultation for this Notice, interested stakeholders should consider submitting comments on the contents of the Notice and the proposed regulations.

By: Maher Haddad, Chicago, Chengwen Tse, San Francisco

HMRC Takes Positive Steps on DeFI

On April 27, 2023, HMRC in the United Kingdom released a second consultation regarding the taxation of transactions in the Decentralised Finance (DeFi) market. In short, HMRC proposes to legislate to ensure that the use of cryptoassets in certain DeFi transactions would no longer give rise to a taxable disposal, but instead would trigger taxation only when the assets are economically disposed of in a non-DeFi transaction.

This is a significant step for HMRC and the UK government in recognizing the growing importance of the DeFi market. Providing clear guidance on the taxation of DeFi transactions is viewed as important to maintaining the UK's position as a leading financial center and fintech innovator.

For more information, please see the full client alert available on InsightPlus.

By: Taylor Reid, Palo Alto and Andrew Stuart, London

Australia's New Anti-Avoidance Measure Targets Payments for Intangibles

On March 31, 2023, the Australian government released draft legislation and an explanatory memorandum regarding a new anti-avoidance measure, which prevents large multinational enterprises from claiming tax deductions for payments relating to intangibles ‘‘connected with low corporate tax jurisdictions”. Baker McKenzie partners in the United States and Australia discuss the mechanics of the new anti-avoidance measure and its implications in their article, A Hammer in a World of Nails: Australia’s New Anti-Avoidance Measure Targeting Payments for Intangibles (52 Tax Mgmt. Int’l J. No. 5 (May 5, 2023).

By: Simone Bridges, Sydney and Ethan Kroll, Los Angeles

Brazilian Senate Approves Provisional Measure Establishing New Transfer Pricing Rules

On May 10, 2023, the Brazilian Federal Senate approved Bill of Law No. 8/2023, originated from Provisional Measure No. 1,152/2022, in order to introduce new transfer pricing rules in Brazil.

The Senate reproduced the wording of the project previously approved by the Chamber of Representatives entirely, despite the claim of some parliamentarians for the insertion of an amendment postponing the entry into force to 2025.

According to the Rapporteur, Senator Jayme Campos, the Brazilian transfer pricing legislation has been in conflict with the international practices for several years, reason why the new rules should be mandatory as of 2024 (with optional adoption for the calendar year of 2023).

The changes introduced by the Bill of Law are aligned with the OECD standards, representing one of the key developments for Brazil to become a member of the Organization.

The Bill of Law will now be analyzed by the President, who will be able to sanction or veto, entirely or partially, the text approved by the Senate, within 15 working days.

It is expected that Normative Rulings will be issued by the Brazilian tax authorities in order to regulate the new rules, especially in relation to: the selection of methods; indication of databases for identifying comparable transactions; conditions for adjustments; the form and conditions for submitting information and specific ancillary obligations; the procedures for submitting rulings requests and other simplification measures/ safe harbors.

By: Clarissa Machado, Luciana Nobrega and Luiz Felipe Camargo, Sao Paulo

Changes to Taxation of Financial Investments, Controlled Companies and Trusts Owned by Brazilian Tax Residents (Individuals)

On April 30, 2023, Provisional Measure 1.171/23 ("MP" or "MP 1.171/23") was published, introducing changes to the taxation of Brazilian tax residents (Individuals), especially regarding: (i) the taxation of financial investments abroad; and (ii) the creation of "anti-deferral" rules for foreign controlled entities owned by Brazilian individuals. In addition, for the first time, this MP deals with the taxation of foreign trusts. MP 1.171/23 also changed the bracket amounts of the progressive tax rates applicable to ordinary income and revoked some specific tax provisions, including specific exemptions applicable to individuals. The new rules shall apply from January 1, 2024 on, provided the provisional measure is timely converted into law, as required in Brazil.

For more information, please see the full client alert available on InsightPlus.

By: Clarissa Machado and Flavia Gerola, Sao Paulo

Plot Twist: New York Legislation Would Give the Commissioner of Taxation and Finance Appeal Rights Following Certain Adverse Tribunal Decisions

As part of the New York Budget Legislation ("S.B. 4009 / A.B. 3009"), which New York Governor Kathy Hochul signed into law on May 3, 2023, the Commissioner of the New York State Department of Taxation and Finance now has the right to appeal certain types of decisions from the New York State Tax Appeals Tribunal. Historically, only taxpayers have had the right to appeal Tribunal decisions. The law is effective immediately and creates additional complexities in New York State tax litigation.

For more details, please see "*Plot Twist: New York Legislation Would Give the Commissioner of Taxation and Finance Appeal Rights Following Certain Adverse Tribunal Decisions*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Mike Tedesco, New York

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Managing the Impact of Economic Volatility on the Workforce

In the first report in our Workforce Redesign: Outlooks for Business Leaders series, we explore how businesses can manage the current economic climate without losing the momentum to build their flexible futures, deep diving into key considerations such as:

- With inflation, rising labor costs and low employment rates, how is the seeming contradiction between lay-off activity and the war for talent playing out?
- What are the consequences for organizations who take a short-term view on workforce reduction to navigating current times?
- Despite avoiding a global recession, companies are still feeling the pinch. What strategies should they have in place to build resilience and optimize outcomes?
- How are companies exploring a more proactive redesign post pandemic? What are the obstacles to embracing new and transformative ways of working?
- How is the rise in remote working being impacted by the current economic climate?

For more information, please see the full article on InsightPlus.

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For further information regarding the North American Tax Practice Group, any of the items or Upcoming Events appearing in this Newsletter, or to receive *Tax News and Developments* directly, please contact Cheryl Johnson at 312-861-3064 or cheryl.johnson@bakermckenzie.com.

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